



MORTGAGE BANKERS ASSOCIATION

January 27, 2014

Honorable Ben S. Bernanke
Chairman
Board of Governors of the
Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
(Docket No. R-1466)

Honorable Thomas J. Curry
Comptroller of the Currency
Office of the Comptroller of the Currency
250 E Street, SW
Washington, DC 20219
(Docket ID OCC-2013-0016)

Honorable Martin J. Gruenberg
Chairman
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
(RIN No. 3064-AE04)

Re: Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring

Dear Sirs:

The Mortgage Bankers Association¹ (MBA) appreciates the opportunity to comment on the proposal *Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring*² (Proposed Rule). The following contains background information and MBA's general comments and observations. Appendix A contains our response to specific questions contained in the Proposed Rule relating to the treatment of real estate finance products.

The following comments relate to concerns MBA and its members have with respect to the Proposed Rule and their potential impact on the desirability and demand for holding

¹ The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,200 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, REITs, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

² 78 Fed. Reg. 71818 (November 20, 2013).

real estate finance products and potential impact on the availability and cost of mortgages to consumers and businesses.

Background

In January 2013, the Basel Committee for Banking Supervision (BCBS), an international committee of bank regulators, issued the Basel III's liquidity coverage ratio (LCR) framework for implementation by the respective member countries. The LCR is intended to ensure that large banks hold sufficient stocks of "high quality liquid assets" (HQLAs) to survive a specified liquidity stress scenario. The Proposed Rule is a draft of the U.S. version of the rule. Although it follows much of the Basel's framework, the Proposed Rule is more restrictive in many respects. Those restrictive aspects related to real estate finance products will be highlighted in the general comments below.

The LCR uses as a numerator the sum of HQLAs and as a denominator the largest net cash outflow in any of the 30 calendar days following the calculation date. The Proposed Rule would apply to bank holding companies and savings and loan holding companies with at least \$250 billion or more in total assets or at least \$10 billion of foreign exposures. The Proposed Rule also introduces a modified LCR standard for bank holding companies and savings and loan holding companies with at least \$50 billion in total assets.

Summary of Recommendations

MBA recommends that the final rule align closely with the Basel Commission's rule so that U.S. banks may play on a level playing field with their overseas counterparts. MBA also recommends that the effective date and transition rules be coordinated with other Basel nations. In addition, MBA recommends:

- The final LCR rule exclude mortgage-backed securities' (MBS) variable interest entity (VIE) liabilities from the cash outflows calculation unless they represent a liquidity facility or other legally binding funding agreement. If cash flows from a VIE's liabilities must be included in the LCR cash flows, they should be included net of estimated cash flows from the linked assets in the securitization trust even if those assets are not on the balance sheet, as is the case for non-consolidated VIEs.
- The Basel LCR framework allows private-label MBS to be included in Level 2B HQLAs whereas the U.S. Proposed Rule would exclude them. MBA believes that the U.S. regulators should not exclude private label MBS from HQLAs. Rather, they should work with other Basel nations to develop a common framework for the inclusion of private label MBS as those markets evolve in the future.

- In order to prevent an adverse impact on the market for Fannie Mae and Freddie Mac securities from the combined impact of Base III risk-based capital rules, the leverage ratio rule, and the Proposed Rule, MBA recommends:
 - Under the leverage ratio rules, the leverage ratio for U.S. banks should be closely calibrated to the ratio used for other Basel nation banks.
 - Under the Proposed Rule, the haircut on GSE MBS should be reduced and the overall limit should be increased or eliminated.
- The U.S. regulators should look to the repo market haircuts on GSE MBS for a market estimate of the short-term risk and reduce the haircut in the Proposed Rule to less than five percent.
- For the denominator of the LCR, mortgage commitment outflows should be netted with projected to-be-announced (TBA) sale inflows.
- MBA seeks clarification that cash outflows for commercial/multifamily loans that have not been fully funded will be limited to the amount of the loan that is scheduled to be funded during the 30-day LCR reporting period, not the entire unfunded amount of the loan.

General Comments

Structured Securities

With respect to structured securities, like MBS, the Proposed Rule would require inclusion in cash outflows of the greater of (1) 100 percent of the amount of all debt obligations that mature 30 days or less, and all commitments made by the issuing entity to purchase assets within 30 days or less from the calculation date, or (2) the maximum contractual amount of funding the covered company may be required to provide to the issuing entity 30 days or less from the calculation date through a liquidity facility, a return or repurchase of assets from the issuing entity, or other funding agreement. This is for all structured transactions sponsored by the covered company, without regard to whether the structured transaction vehicle that is the issuing entity is consolidated on the covered company's balance sheet. This would pull in all private-label MBS that are sponsored by a covered bank.

Consolidated Variable Interest Entities (VIEs) – Under Financial Accounting Standard No. 167 (FAS 167), a reporting entity must consolidate the assets and liabilities of a variable interest entity (VIE), like a mortgage-backed security, if it has both (1) the power to direct those activities that most impact the economic results of the VIE and (2) the reporting entity has a potentially significant variable interest in the VIE. We note that MBS VIEs that are included in a reporting entity's consolidated financial statements have assets that the reporting entity does not own and liabilities that it does

not owe. Thus, the debt holders of a VIE can only look to the assets held in the VIE and not the assets of the reporting entity for repayment of the debt. Therefore, to include those obligations in a reporting entity's cash outflows would erroneously understate the LCR. The reporting entity's exposure to cash outflows relates only to the variable interest it holds plus legally binding funding arrangements. If the latter exists, they should be included in the estimated cash outflows.

Non-consolidated VIEs – For non-consolidated VIE's there is an even more compelling case for excluding the VIE's debt from the calculation of cash outflows. The variable interest that the reporting entity owns is just not material or potentially material. Like consolidated MBS VIEs, the reporting entity neither owns the assets nor owes the liabilities of the VIE trust.

MBA recommends that the final LCR rule exclude MBS VIE liabilities from the cash outflows calculation unless they represent a liquidity facility or other legally binding funding agreement. If cash flows from a VIE's liabilities must be included in the LCR cash flows, they should be included net of estimated cash flows from the linked assets in the securitization trust even if those assets are not on the balance sheet, as is the case for non-consolidated VIEs.

Private Label MBS Excluded Entirely from Liquid Assets

The proposal would exclude from Level 2B liquid assets private-label MBS in any amount. In contrast, the Basel III LCR proposal generally permits the inclusion of private-label MBS in Level 2B liquid assets subject to a 25 percent haircut. This would put U.S. banks on an unlevel playing field compared with their foreign competitors.

MBA believes that the U.S. regulators should not exclude private label MBS from HQLAs. Rather, they should work with other Basel nations to develop a common framework for the inclusion of private label MBS (backed by residential or commercial/multifamily real estate) as those markets evolve in the future. The goal should be to encourage the flow of private capital into the private-label MBS markets, and sufficiently liquid RMBS and CMBS should be permitted to qualify as HQLAs.

Combined Impact of the Proposed LCR Rule, Basel III, and the Proposed Leverage Ratio on Bank Holdings of GSE MBS

The largest 25 banks currently hold close to \$1.1 trillion of agency securities and Collateralized Mortgage Obligations (CMOs). This represents almost 25 percent of agency debt instruments outstanding. For this reason, large banks are a key market for GSE securities, and GSE MBS and GNMA MBS have dominated the secondary market for mortgages since 2008. MBA's concern is that the combined effect from the Proposed LCR Rule, Basel III and the Proposed Leverage Ratio could disrupt the housing and real estate finance market, adversely impacting the availability and increasing the price of home loans to consumers, especially for first-time homebuyers.

The following are the negative features of each which, in combination, will provide incentive for large banks to reduce their holdings of GSE MBS:

1. **Proposed LCR Rule** – Requires a haircut of 15 percent for GSE MBS, and the overall amount of such assets, coupled with other Level 2A and Level 2B assets would be limited to 40 percent of the total stock of HQLA assets.
2. **Basel III for Advance Filers** – Would require other comprehensive income (OCI) on available for sale (AFS) securities to be included in the determination of Tier 1 capital. Many of the GSE securities of large banks are included in the AFS category. This could result in some potential volatility in reported capital at the end of the quarter, and thus provide additional incentive for large banks to reduce their holdings of GSE securities.
3. **Proposed Leverage Ratio** – In 2010, the Basel Committee for Banking Supervision (BCBS) issued the Basel III regulatory capital framework for implementation by the respective member countries. In addition to an update of the risk-based capital (RBC) framework, Basel III included a supplemental leverage ratio in which the denominator is measured using average on-balance sheet assets plus certain off-balance sheet exposures. The numerator is Tier 1 capital. In the leverage ratio, the assets in the denominator are not risk-weighted. The proposed minimum leverage ratio was set at three percent.

The risk-weighting of assets makes the RBC ratio a more precise measure of balance sheet safety and soundness. The leverage ratio, which is a blunt regulatory instrument, ignores the riskiness of the respective assets and focuses on overall leverage. It is meant to be a backstop to the RBC ratio to prevent a bank from loading up on low risk assets, like U.S. Treasury securities and Ginnie Mae MBS, which have a zero percent risk weight but still carry some interest rate risk.

The proposed leverage ratio rule is applicable to the top eight banks in the United States and would raise the leverage ratio minimum to five percent for bank holding companies and to six percent for insured depositories owned by those bank holding companies. The eight banks are far from compliant with the proposed leverage ratio rule. Bank regulators acknowledge that using data from the third quarter of 2012, the eight bank holding companies would have to raise \$63 billion in total Tier 1 capital to meet the proposed ratio.³ Further, a prudent bank will want to maintain a safety margin in its regulatory capital ratios to prevent falling out of the “well-capitalized” category, so the capital deficit is really much higher than the \$63 billion suggested.

³ *Federal Register*, Volume 78, No. 161, Tuesday August 20, 2013, page 51107.

Companies attempt to maximize profit and return for shareholders within economic and regulatory constraints. Today's RBC regime defines the scarce resource as capital, and capital is allocated to various loans and investments based upon RBC and return on that RBC. By raising the leverage ratio to the point where capital becomes scarcer from a leverage ratio standpoint than from a RBC standpoint, in order to maximize profits, banks may turn to return on assets (ROA) as the primary tool to allocate scarce capital. This could result in irrational decision-making from a safety and soundness standpoint and increase instead of decrease the systemic risk posed by large banks. For example, unsecured commercial loans or credit card loans, which have a higher ROA than repos collateralized by U.S. Treasury bills or Agency mortgage-backed securities, may be the incremental asset of choice. Thus the proposed leverage ratio rule would provide yet another incentive for large banks to reduce their holding of GSE securities.

The treatment of OCI is already part of the final Basel III rule. However, bank regulators still have the opportunity to change the course charted for the treatment of GSE securities under the proposed LCR and leverage ratio rules. Under the leverage ratio rules, the leverage ratio for U.S. banks should be closely calibrated to the ratio used for other Basel nation banks. MBA notes that the U.S. regulators announced in December 2013 that they would slow down the leverage ratio rulemaking process to look to reducing the proposed minimum leverage ratio to one more closely aligned to the final rule for other Basel nations. MBA lauds this and encourages U.S. regulators to lock-step the minimum leverage ratio with the ratios other Basel nations adopt. Under the proposed LCR rule, the haircut on GSE MBS should be reduced and the overall limit should be increased or eliminated.

Haircut for GSE MBS Is Too High

The proposed 15 percent haircut on GSE MBS is much too high relative to the risks associated with MBS. Meanwhile, credit risk for GSE MBS is low. In order for an investor to lose any money from a credit risk standpoint, the borrower has to default, the real estate market needs to decline significantly, and the government needs to decline backing the bonds. This is unlikely to happen and is even less likely to happen in a 30-day period of time. From an interest rate risk standpoint a 15 percent loss would be equivalent to a three-to-four percent increase in interest rates during the 30-day time horizon. So, mortgage interest rates would have to double overnight. This has not happened historically in the United States.

GSE securities are highly liquid investments. The U.S. regulators should look to the repo market haircuts on GSE MBS for a market estimate of the short-term risk and reduce the haircut to less than five percent.

Mortgage Commitment Outflows Must Be Included Without TBA Inflows

The proposed LCR rule requires reporting entities to include commitments to make residential mortgage loans within a 30-day stress period in cash outflows at an outflow rate of 10 percent. The proposed rule would not include as inflows proceeds from the potential sale of mortgages in the to-be-announced (TBA), specified pool, or similar forward sales markets. MBA believes that the TBA market is highly liquid in all phases of the cycle and such sales should be considered in determination of the net outflows related to mortgage commitments.

Commercial Real Estate Loans

The Proposal assigns a 100 percent outflow rate to special purpose entities (SPEs).⁴ Because lenders often require commercial and multifamily properties to be structured as SPEs, MBA is seeking clarification for the portion of the loan that has not been funded that would be subject to the 100 percent outflow rate. MBA requests clarification in the Final Rule that only the portion of the unfunded loan that is scheduled to be funded within the 30-day LCR reporting period would be subject to the 100 percent outflow rate.

This is especially significant for construction loans that have been placed within a SPE structure. Funding of construction loans is typically tied to a draw schedule, which can be dependent on construction milestones being met. Construction draws are intended to align the amount of the construction loan that has been advanced to the borrower with the level of project completion. Naturally, lenders are wary to advance funds that are well in advance of the level of project completion. Consequently, during the initial phase of construction, a modest percent of the construction loan has typically been funded. Consequently, should the unfunded portion of these loans be subject to the 100 percent outflow rate, this would be highly punitive for banks because this outflow amount (100 percent x unfunded portion of the construction loan) would greatly exceed the construction loan draw potential in the 30-day LCR reporting period. Consequently, it is essential that the outflow amount be limited to no more than the 30-day construction loan draw potential specified in the loan documents.

Because projects under construction are not producing income, it is a common practice for lenders to include interest payments in the loan funding. Such funding is credited to the bank, which is not included in the construction draw paid to the borrower. Because these interest payments are not reflected in the construction draw paid to the borrower and are directly credited to the bank, MBA recommends that such interest payments be excluded from outflows used to calculate the LCR.

Certain borrowers⁵ obtain lines of credit from banks that are not fully drawn when the line of credit is made. These lines of credit can be used to fund the acquisition of

⁴ 78 Fed. Reg. at 71838.

⁵ These can include commercial real estate investment funds, equity REITs, and real estate operating companies.

properties. In the loan documents, these lines of credit typically have limitations on how much of the line of credit can be used at any point in time. Similar, to construction draws, MBA strongly encourages that only the amount of credit line that is available for use during the 30-day LCR reporting period should be included in outflows. Because these loans are used to purchase and maintain properties, under the Proposed Rule, they would be appropriately classified as a credit facility.⁶ The outflow rate should be based upon the credit facility classification with the following outflow rates: five percent for small business; 10 percent for non financial sector companies; 40 percent for investment companies; and 100 percent for SPEs.⁷ For each borrower, the appropriate outflow rate should be assigned that is based on the existing regulatory classification of the borrower.

Attached please find in Appendix A MBA's responses to specific questions posed in the Proposed Rule.

MBA appreciates the opportunity to comment on the Proposed Rule. Any questions on MBA's response should be addressed to Jim Gross at 202-557-2860 or jgross@MBA.org.

Sincerely,



David H. Stevens
President and CEO

⁶ The alternative classification would be a "liquidity facility" that would provides funding "expressly for the purposes of refinancing debt to a counterparty when it is unable to obtain a primary or anticipated source of funding". See 78 Fed. Reg. at 71837.

⁷ 78 Fed. Reg. at 71838.

Responses to Specific Questions

14. *What alternative treatment, if any, should the agencies consider for obligations of U.S. GSEs and why? Provide justification and supporting data.*

MBA's Response: MBA believes that the combined impact of the Proposed LCR rule, Basel III, and proposed leverage ratio rules could have the impact of dramatically reducing the demand by large banks for GSE securities and this could adversely impact overall demand for such securities. Likewise, MBA believes the proposed haircut for GSE MBS is far too high and is not supported by market metrics. See general comments above titled *Combined Impact of the Proposed LCR Rule, Basel III and the Proposed Leverage Ratio on Bank Holdings of GSE MBS and Haircut for GSE MBS Is Too High*.

15. *What, if any, additional criteria should the agencies consider in determining the type of securities that should qualify as level 2B liquid assets? What alternatives to the S&P 500 should be considered in determining the liquidity of an equity security and why? In addition to an investment grade classification, what additional characteristics denote the liquidity quality of corporate debt that the agencies would be legally permitted to use in light of the Dodd-Frank Act prohibition against agencies' regulations referencing credit ratings? The agencies solicit detailed comment, with supporting data, on the advantages and disadvantages of the proposed investment grade criteria as well as recommended alternatives.*

MBA's Response: The Basel LCR framework allows private-label mortgage-backed securities to be included in Level 2B HQLAs whereas the U.S. Proposed Rule would exclude them. MBA believes that the U.S. regulators should not exclude private label MBS from HQLAs. Rather, they should work with other Basel nations to develop a common framework for the inclusion of private label MBS as those markets evolve in the future. See general comment above titled *Private Label MBS Excluded Entirely from Liquid Assets*.

37. *What, if any modifications to the structured transaction outflows should the agencies consider? In particular, what, if any, modifications to the definition of structured transaction should be considered? Please provide justifications and supporting data.*

MBA's Response: MBA believes that the final LCR rule should exclude MBS VIE liabilities from the cash outflows calculation unless they represent a liquidity facility or other legally binding funding agreement. If cash flows from a VIE's liabilities must be included in the LCR cash flows, they should be included net of estimated cash flows from the linked assets in the securitization trust even if those assets are not on the balance sheet, as is the case for non-consolidated VIEs. See general comment above titled *Structured Securities* for more detail.³⁹ *Is it appropriate to exclude forward sales*

of mortgage loans from the treatment of derivatives contracts under the proposed rule? Why or why not?

MBA's Response: A reporting entity must include commitments to make loans in its cash outflow. TBA forward commitments to sell loans should be included in the cash inflows for Ginnie Mae and GSE securities. See comment above titled *Mortgage Commitment Outflows Must Be Included Without TBA Inflows*.

41. What effect may the treatment for retail mortgage funding under the proposed rule have on the banking system and the mortgage markets, including in combination with the effects of other regulations that apply to the mortgage market? What other treatments, if any, should the agencies consider? Provide data and other supporting information.

MBA's Response: See comment above titled *Mortgage Commitment Outflows Must Be Included Without TBA Inflows*.