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Board of Governors of the
Federal Reserve System
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Washington, DC 20551
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Washington, DC 20219
(RIN 1557-AD46)

Federal Deposit Insurance Corporation
550 17th St, NW
Washington, DC 20429
(RINs 3064-AD95, 3064-AD96, and 3064-AD 97

Re: Regulatory Capital Rules:

A. Regulatory Capital, Implementation of Basel III: Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions and Prompt Corrective Action (Regulatory Capital Rule)
B. Standardized Approach for Risk-Weighted Assets: Market Discipline and Disclosure Requirements (Standardized Approach)
C. Advanced Approaches Risk-based Capital Rule: Market Risk Capital Rule (Advanced Approach)

To Whom It May Concern:

The Mortgage Bankers Association[i] (MBA) thanks the Board of Governors of the Federal Reserve System (Fed), the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC) (collectively the Regulators) for

[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.

the opportunity to comment on the three proposed regulatory capital rules (the Proposal). Following please find an executive summary of MBA's comments, an introduction which contains a "deeper dive" summary of MBA's recommendations, a historical perspective and economic and market analysis summary of the proposed rules, and MBA's comments on the proposed rules impact on specific real estate finance assets and activities.

Executive Summary

The following are MBA's recommendations:

General Themes

- The Proposal would create an unlevel playing field for U.S. banks relative to their European counterparts. This is contrary to the spirit and intent of the Basel Accords.
- The Proposal would adversely affect consumers by creating artificially tight credit conditions and higher costs.
- The layering of Basel III on top of other new or proposed rules would stifle real estate finance.
- Improper risk-weighting would lead to uneconomic decisions concerning assets and liabilities.
- The complexity of the Proposal and resulting cost and infrastructure required to comply with the proposal will be onerous for community banks. Regulators need to find ways to minimize the complexity and added burden for community banks.

Impact on the Mortgage Market from Basel III

The Proposal will impact the mortgage market along several dimensions:

- Increased capital requirements will reduce overall lending relative to the existing standards.
- Increased risk-weights for mortgage loans, particularly for loans with certain specified characteristics or features, will concentrate bank mortgage holdings in loans without these characteristics and concentrate loans with such characteristics in other capital sources.
- Penalties on mortgage servicing rights (MSRs) above a 10 percent threshold could result in a major market disruption as servicing is dispersed from large holders to other institutions that may or may not have the capacity to economically service mortgages.

In addition to these global impacts, the new standards would impose higher costs of compliance across the board. Thus, it has the potential to have a negative impact on mortgage lending broadly, given the market share of the larger institutions, and impose

higher costs of compliance on smaller institutions that likely already meet the level of capital required.

Mortgage Servicing Rights (MSRs)

- The structure of mortgage servicing is unique to the U.S., as is the importance of MSRs for banks. The existing treatment of MSRs is appropriate for the U.S. system and should be continued.
- If regulators insist upon limiting MSRs on the balance sheets of banks, MBA would ask that the proposal be changed to increase the allowable ratio of MSRs to Tier 1 capital to at least 25 percent for commercial banks and 50 percent for savings and loan associations as opposed to the proposed 10 percent. Our comments also address other means to lower the potential costs and disruption of this provision.
- Commercial/multifamily MSRs should be excluded from any rule changes because they do not have significant prepayment default risk.

Residential Mortgage Loans

- Risk weights for properly underwritten mortgage loans are currently more than sufficient. MBA recommends eliminating the proposed new mortgage categories, and retaining the 50 percent risk-weight, or at the least harmonizing these new risk-weights with those of other Basel nations rather than putting U.S. banks at a competitive disadvantage.
- As in current regulation, MBA would recommend that higher loan-to-value (LTV) mortgage loans with mortgage insurance provided by financially strong counterparties be included in the calculation of the LTV ratios used for purpose of risk-weighting, as mortgage insurance clearly reduces loss severity.

Commercial Real Estate Loans

- Recommend a 50 percent risk-weight for commercial mortgages that is modeled after the European Commission's rule for commercial loans and for U.S. multifamily loans that meet certain underwriting requirements.
- For certain acquisition, development and construction (ADC) loans, the difference between the land's fair market value and its purchase price should be included in the 15 percent contributed capital requirement in order to avoid being unnecessarily placed in a higher risk-weight category.

Securitization Exposures

- The proposed risk-weight treatment of private-label securitizations held by banks is excessive along a number of dimensions.
- If a policy goal is to increase private capital's role in the market, this proposal will work counter to that goal.

- The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) eliminates the ability of regulators to use Nationally Recognized Statistical Rating Organization (NRSRO) credit ratings for establishing risk-weights. However, the alternative proposed here, the simplified supervisory formula approach (SSFA), falls short and will constrict the availability of credit.
- Additionally, the Proposal's alternatives to the SSFA, the gross-up approach and the 1,250 percent risk-weight approach (100 percent capital requirement) both produce risk-weights that are even more severe than the SSFA.
- MBA recommends that the Regulators recalibrate the SSFA in a manner that will allow it to more closely approximate the risk-weights of competing European Union (EU) financial institutions.

Until the SSFA is recalibrated, the current ratings-based approach should remain in place for structured securities.

Other Recommendations

Fannie Mae & Freddie Mac (GSEs) MBS

- Fix the treatment of credit-enhancing representations and warranties as it relates to FHFA's new policy framework for seller reps and warranties.

Treatment of Fannie Mae and Freddie Mac Multifamily MBS

- For multifamily MBS that are guaranteed by Fannie Mae and Freddie Mac, MBA strongly supports the 20 percent risk-weight.
- For the tranches of a multifamily MBS that are guaranteed by either Fannie Mae or Freddie Mac, MBA strongly supports the "substitution approach" that allows the 20 percent risk-weight to be applied to the multifamily tranches that Fannie Mae and Freddie Mac guarantee.
- Tranches of a multifamily MBS that are not supported by Fannie Mae or Freddie Mac guarantees should receive the same capital treatment as private-label MBS.

Commercial and Multifamily Servicer Cash Advances

- Advance obligations in CMBS transactions have not provided credit support to the investor, loans to the borrower or fund liquidity needs since the inception of CMBS. We therefore recommend that these liquidity advances be excluded from the risk-weighting requirements included in the Proposal.
- Barring this exclusion, MBA has provided recommendations to minimize the impact of risk-weighted servicer advances.

Other Comprehensive Income

- Continue to exclude unrealized gains and losses in Other Comprehensive Income from the definition of regulatory capital. This will avoid unnecessary volatility in risk-based capital.

Financing Independent Mortgage Companies

- Include conforming and/or FHA/VA residential mortgages in the definition of financial collateral.
- Allow reporting entities to "look through" a repo structure to the financial collateral held therein.

Off-Balance Sheet Exposures

- Continue the existing 120-day safe harbor for credit-enhancing reps and warranties.

Residential Mortgage Loans Sold With Recourse

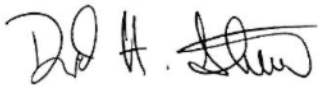
- Allow for capital reserved against the converted exposure to be added into Tier 2 capital as an Allowance for Loan and Lease Losses.

MBA Recommendation

MBA believes that the differences between the U.S. version of Basel III and the proposals for the European Commission are so pervasive that U.S. banks will have a major disadvantage in competing with overseas banks. **MBA believes that the prudential bank regulators in the U.S. need to re-think the entire proposed structure, and after addressing the Proposal's problematic elements raised herein, re-issue the Proposal for comment.**

MBA appreciates the opportunity to share its comments with you. Any questions about the information provided herein should be directed to Jim Gross, Vice President Financial Accounting and Public Policy and Staff Representative to MBA's Financial Management Committee, at (202) 557-2860 or jgross@mortgagebankers.org.

Yours truly,



David H. Stevens
President and Chief Executive Officer

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I. Introduction

Proposals Create Unlevel Playing Field for U.S. Banks

The Basel Committee on Banking Supervision (Basel Committee) provides a forum for regular cooperation on banking supervisory matters in order to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. One of the things the Basel Committee has undertaken for over 20 years is to develop standard international capital adequacy standards that are to be voluntarily adopted by member countries.

The benefits of common capital standards are especially important as more and more banks compete on a global basis. In the absence of clear, common capital standards, banks domiciled in countries with strict capital standards could be at a competitive disadvantage to their foreign counterparts. There would effectively be an opportunity for "risk-based capital arbitrage."

One of MBA's principal observations is that the U.S. version of Basel III would in fact move banks in the United States further away from capital standards in place around the world --- especially in the real estate finance area. The following are examples:

- Overseas banks would be required to reduce the common equity component of Tier 1 capital by the mortgage servicing rights (MSRs) in excess of 10 percent of the common equity component of Tier I capital. U.S. banks would be required to do the same and would still be required to take an existing 10 percent of the fair value of MSRs as an additional haircut from Tier 1 capital.
- Under the European Commission proposal, an exposure "fully and completely secured by mortgages on a residential property which is or shall be occupied or let by the owner, or the beneficial owner in the case of personal investment companies, shall be assigned a risk-weight of 35 percent."[2] The Proposals would require residential mortgage loans to be placed in one of two categories, and based upon the category and the loan-to-value (LTV) ratio, risk-weights would range from 35 percent to 200 percent.
- Another significant departure of the Proposals from the European Commission's proposed version of Basel III is the exclusion of credit ratings in determining risk-based capital for structured securities. This was prompted by section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act[3] (Dodd-Frank Act) which required all federal agencies to remove references to and requirements of reliance on credit ratings from their regulations and replace them with appropriate alternatives for evaluating creditworthiness. Both the simplified

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[2] European Commission, *Proposal for a Regulation of the European Parliament and of the Council*, July 7, 2011.
3 Public Law 111-203, 124 Stat. 1376-2223 (July 21, 2010).

supervisory formula approach (SSFA) and the gross-up approaches would result in higher risk-weightings on securitization exposures.
- The European Commission Basel III proposal would allow a 50 percent risk-weight for commercial mortgage that meet certain loan to value thresholds. The U.S. version of Basel III maintains the existing 100 percent risk-weight for performing commercial loans.

MBA believes that the differences between the U.S. version of Basel III and the proposals for the European Commission are so pervasive that U.S. banks will have a major disadvantage in competing with overseas banks. **MBA believes that the prudential bank regulators in the U.S. need to re-think the entire proposed structure, and after addressing the Proposal's problematic elements raised herein, re-issue the Proposal for comment.**

Proposals Would Adversely Impact Consumers

Increasing risk-weighting on residential mortgages would adversely impact consumer pricing. For example,

- A category 1 mortgage loan with an 80 percent LTV would price approximately 16 basis points (bps) higher under the Proposal.
- A category 2 mortgage loan with an 80 percent LTV and a category 1 loan with 95 percent LTV would each price 85 basis points higher under the Proposal.
- A category 2 loan with 95 percent LTV and private mortgage insurance would price 2.21 percent points higher under the Proposals.

The Proposal coupled with the Dodd-Frank Act ability to repay criteria would shut out of the market many consumers who have low down payments, including many first-time homebuyers.

(See Appendix E for calculations of consumer impact)

Adverse Impact of the Layering of New Laws, Rules and Regulations

As noted in the *Historical Perspectives and Economic and Market Impact* section below, in response to the recession and financial crisis, a series of new standards and regulations have been adopted and/or proposed along a number of dimensions, all with the potential to reduce the supply of mortgage credit and collectively to prevent significant private capital from returning to the real estate finance market.

The U.S. version of the proposed Basel III capital standards would add to these regulatory and market reactions, likely significantly curtailing real estate lending by the banking sector. The net effect would be a reduction in stable, collateralized lending opportunities for banks; a reduction in funding for a critical sector of the economy; and a migration of assets with excessive capital charges from banks to other investor groups that are not subject to the Proposal's risk-based capital approach.

The pendulum has clearly swung too far, and regulators need to be very careful that they do not curtail the desire and ability of the banking system to hold and service mortgages at the very same time that the market is still recovering and federal housing policymakers would like to see private capital re-enter the market.

Improper Risk-Weighting Will Lead to Uneconomic Asset/Liability Decisions

Banks allocate capital to products based upon risk-based capital rules. If a specific asset is assigned a risk-weighting that far exceeds the asset's inherent risks, the bank will price that product higher in order to achieve required return on equity. If such pricing changes aren't met by competitors like non-banks, then the bank will not be able to compete.

Overweighting capital costs for real estate lending by the banking system would drive this important investment opportunity to other capital providers – depriving banks of a key investment option and depriving real estate borrowers of a stable, secure source of funding.

Some of the contrasts in the proposed risk-weights are noteworthy. Mortgage servicing rights (MSRs) would be risk-weighted at 250 percent and residential mortgages up to 200 percent, while unsecured commercial loans to corporate borrowers and unsecured credit card receivables from consumers would be risk-weighted only 100 percent.

The banking sector as a whole is one of the largest players in the mortgage market, and special care should be taken in contemplating any additional requirements that would further constrain the ability of banks to lend.

Summary of Concerns and Recommendations:

Mortgage Servicing Rights

In addition to the existing 10 percent haircut against Tier 1 capital, the Proposals would require that MSRs in excess of the 10 percent of common equity component of Tier 1 capital be deducted from Tier 1 capital. Further, the aggregate of MSRs, certain deferred tax assets, and equity in unconsolidated subsidiaries would be subject to a limit of 15 percent of the common equity component of Tier 1 capital. Any excess above that limit would have to be deducted from the common equity component of Tier 1 capital. For securitization exposures, MSRs would be required to be deducted from Tier 1 capital as a non-cash gain on sale, and certain servicing advances would require a risk-weight of 1,250 percent. Lastly, MSRs not deducted from capital would be risk-weighted at 250 percent.

MBA finds such treatment excessive and an over-reaction to the recent economic crisis. The Proposal will likely drive a large portion of servicing from banks to less regulated entities and increase consumer pricing.

MBA believes that existing regulatory capital treatment of MSRs is appropriate, and the Proposal's limits on MSRs should not be adopted in the U.S. If, however, U.S. bank regulators move forward with the proposed treatment, MBA recommends that its impact be reduced in order to ensure that the mortgage market is not adversely impacted. MBA specifically recommends:

- Reduce the existing haircut under the FDIC Improvement Act of 1991(the Act) to 0 percent, as allowed under the Act. This would put U.S. banks on a level playing field with other banks, prior to implementation of proposed MSR restrictions.
- The MSR cap before deduction from the common equity component should be raised to a higher level. MBA recommends the use of a 25 percent cap for MSRs on the books of commercial banks. The present capital rules allow depositories with a thrift charter a higher threshold than those with a bank charter in order to further promote mortgage lending by savings and loan associations. Basel III should continue to recognize this important differential in its limits of MSRs. MBA therefore recommends a 50 percent cap for MSRs on the books of savings and loans.
- MSRs should not be included in the 15 percent cap.
- Servicing of commercial real estate should be carved out completely from the application of the Proposal because of the absence of prepayment risk and the fact that servicing fees are received on assets in default.
- MSR assets should be risk-weighted at 100 percent.

Residential Mortgage Loans

The Proposal contains several changes to existing risk-based capital rules that will have a dramatic and negative impact on the residential mortgage market. Risk-weights for properly underwritten mortgage loans are currently more than sufficient. MBA recommends eliminating the proposed new mortgage categories, and retaining the 50 percent risk-weight, or at the worst harmonizing these new risk-weights with those of other Basel nations rather than putting U.S. banks at a disadvantage.

As in current regulation, MBA recommends that higher-LTV mortgage loans with mortgage insurance provided by financially strong counterparties be assigned the same 50 percent risk-weight as mortgage insurance clearly reduces loss severity.

<u>New Categories and Risk-Weights Would Put U.S. Banks on an Unlevel Playing Field</u>

The Proposal would create two categories of mortgages based on characteristics primarily related to borrower's ability to repay. The ranges of risk-weights would be based upon loan-to-value (LTV) ratios and would range from 35 percent to 200 percent. In contrast, the European Commission would require a risk-weight of only 35 percent.

MBA recommends that the U.S. regulators eliminate the proposed new mortgage categories and align proposed risk-weights with other Basel nations.

Interaction of Proposed Categories and CFPB's Proposed Ability to Repay Rules

If U.S. regulators insist on banks using the proposed categories of residential mortgages, then MBA believes the vast majority of loans in existence now and to be originated in the future should fall under the definition of Category 1 as follows:

- The Dodd-Frank Act requires that all residential mortgages made are subject to nationwide ability to repay standards, and the Consumer Financial Protection Bureau (CFPB) is expected to finalize rules under this provision of the Dodd-Frank Act early in 2013. Since all loans must meet ability to repay standards and that is the key point to define Category 1 loans, it makes sense that virtually all U.S. residential loans should be deemed to be Category 1 mortgages.
- MBA believes that seasoned loans that are performing already demonstrate the ability to repay, and thus should be "grandfathered" as Category 1 loans.
- MBA also believes that loans underwritten since the summer of 2010 have been underwritten and documented with the Dodd-Frank Act requirement of ability to repay in mind. Thus, MBA also recommends that unseasoned, loans likewise be "grandfathered" as Category 1 loans unless there is evidence of early payment default relating to circumstances that existed at the date the loan was underwritten.

High Risk-weights and Cliff Effect

MBA believes that the proposed risk-weights for Category 2 loans are an overreaction.

MBA recommends that the risk-weight for Category 2 loans be reduced to a range from 50 percent to 150 percent. Further, MBA is concerned that limiting the LTV tranches to only four tranches will potentially result in a "cliff effect" when mortgages shift between categories. Accordingly, MBA recommends that the number of LTV tranches be expanded to at least six tranches.

Exclusion of Private Mortgage Insurance (MI) from LTV Calculation

Under the Proposal, the risk-weight of a particular mortgage is dependent upon the LTV calculation. However, the Proposal would exclude loan level MI from this calculation. The Regulators state the reason for excluding MI from the calculation relates to varying degrees of financial strength of MI providers.

MI works to significantly reduce loss severity, and MBA recommends that it be included in the LTV calculation under the Proposal. MBA believes that the Regulators should work with the MI industry and their regulators to develop a regime that will require stress testing of each company's claims paying ability in order for their MI policy to be included in the LTV calculation.

Commercial Real Estate Loans

The European Commission has proposed a 50 percent risk-weight for commercial real estate loans with a 50 percent LTV. However, the Proposal would maintain the existing 100 percent risk-weight for commercial real estate mortgages.

MBA believes that the European Commission's concept for a reduced risk-weight for commercial mortgages that meet certain underwriting conditions should be adopted by U.S. regulators. Additionally, it is consistent with the 50 percent risk-weight for the "statutory mortgage" that MBA strongly supports for multifamily loans that meet certain underwriting requirements.

The Proposal also addresses acquisition, construction, and development loans (ADC loans) through the introduction of the High Volatility Commercial Real Estate Exposures (HVCRE) risk-weight. For these loans, the risk-weight increases from 100 percent to 150 percent. This status is triggered for ADC loans when the LTV is greater than 80 percent and the property owner has contributed capital of less than 15 percent. MBA supports the HVCRE risk-weight but recommends that the developer be allowed to include in the 15 percent contributed capital requirement the difference between the land's fair market value and its purchase price. This is consistent with the existing practice of bankers treating these savings as contributed capital because they reduce the development budget on a dollar-for-dollars basis.

Securitization Exposures

The proposed treatment of private-label securitizations is excessive along a number of dimensions. If a policy goal is to increase private capital's role in the real estate market, the Proposal is counter to that goal. The Dodd-Frank Act eliminates the ability of regulators to use Nationally Recognized Statistical Rating Organization (NRSRO) credit ratings. However, the alternative proposed here falls short and will constrict the availability of credit.

The Proposal gives banks with securitization interests three alternatives for calculating risk-weight:

1. A banking organization may determine the risk-weight for the securitization exposure using the <u>simplified supervisory formula approach</u> (SSFA) described in section 43 of the proposal.
2. A banking organization may use the existing <u>gross-up approach</u> to risk-weight all of its securitizations.
3. Alternatively, a banking organization may apply a <u>1,250 percent risk-weight</u> to any of its securitization exposures, which is 100 percent of the asset's value.

MBA is concerned that these approaches have the potential to go beyond the intent of section 939A of the Dodd-Frank Act of not simply replacing credit ratings with an alternative risk-based capital formulation — but also substantially increasing the risk-based capital held by banks --- far beyond what European Union (EU) country banks will be required to hold in risk-based capital.

We urge the Regulators to recalibrate the SSFA in a manner that will allow it to more closely approximate the risk-weight of competing European Union financial institutions. Until this is completed, **MBA strongly recommends that the existing ratings-based risk-weight methodology remain in place**.

Analysis of the Structured Security Risk-Weight Methodologies

In order to analyze the risk-weight requirements for the U.S. risk-weight options as well how these would compare to EU country requirements, MBA analyzed the following risk-weight methodologies: 1,250 percent risk-weight approach, the U.S. Basel ratings-based approach (U.S. Framework) the EU ratings-based approach (EU Framework); the SSFA; and the gross-up approach. As shown in Table 1, this analysis was performed using a representative example of a CMBS that was issued in 2012, UBS-B 2012-C2.

Table 1
Risk-Based Capital Methodology for Structured Securities
Risk-Based Capital and Risk-Weights for CMBS Issuance UBS-B 2012-C2

Risk-Based Capital Methodology	Risk-Based Capital As Percent of CMBS	Risk-Weight
U.S. Basel Market Risk Framework	10.1%	126.2%
EU Basel Market Risk Framework	7.0%	87.5%
1250% Risk Weight Approach	100.0%	1250.0%
SSFA	16.3%	203.7%
Gross-Up Approach	38.7%	484.0%
Commercial Real Estate Loans	8.0%	100.0%

As indicated in the Table 1, the risk-weight for this CMBS generated by the SSFA was at least 100 percent greater than commercial real estate loans that a bank would hold in its lending portfolio (203.7 percent versus 100 percent). In addition, the SSFA generated a significantly higher risk-weight than the U.S. Basel Market Risk Framework (ratings-based approach) for CMBS, 10.1 percent versus 16.3 percent.

Because the gross-up approach requires excessive risk-weight (100.0 percent) for the highest subordinated CMBS position, MBA is recommending a 20 percent risk-weight, "safe harbor" for CMBS positions with 30 percent or greater subordination levels. This will allow financial institutions to invest in CMBS securities with low default risk that utilize the gross-up approach.

Treatment of Fannie Mae and Freddie Mac Multifamily Mortgage-Backed Securities

For multifamily MBS that are issued and guaranteed by Fannie Mae and Freddie Mac, MBA strongly supports the 20 percent risk-weight. For the tranches of a multifamily MBS that are guaranteed by either Fannie Mae or Freddie Mac, MBA strongly supports the "substitution approach" that allows the 20 percent risk-weight to be applied to the multifamily tranches that Fannie Mae and Freddie Mac guarantee. We recommend that tranches of a multifamily MBS that are not supported by Fannie Mae or Freddie Mac guarantees should receive the same capital treatment as private-label MBS. For risk-weight and for financial accounting purposes, these non-guaranteed tranches should be treated separately from the Fannie Mae and Freddie Mac guaranteed multifamily MBS tranches in order that non-guaranteed tranches not inadvertently trigger enhanced risk-weight for the guaranteed multifamily MBS tranches. With this clarification, MBA supports the risk-weight treatment of Fannie Mae and Freddie Mac multifamily MBS in the Proposal.

Commercial and Multifamily Servicer Advances

The Servicer Cash Advances section of the Proposal addresses the treatment of servicing advance facilities provided by banking organizations to advance funds for liquidity purposes.[4] The section specifically defines these facilities as securitization exposures but limits risk based capital holding in the event that the undrawn portion of the facility is an eligible cash advance facility. MBA questions if this provision was meant to cover the types of advances made in U.S. commercial/multifamily lending.

Advance obligations in CMBS transactions do not provide credit support to the investor, loans to the borrower or fund liquidity needs of either. MBA is unaware of any loss incurred by a servicer in relation to its advancing obligations since the inception of CMBS. We therefore recommend that these liquidity advances be excluded from the risk-weight requirements included in the Proposal.

In the event that these advances are not excluded from these risk-weighting requirements, we request the following changes:

1. Eliminate references to 'facilities' when addressing these advances and refer instead to the servicer's liquidity advance obligation. This change in terminology will allow for a distinction between these advances and the loans or other credit support traditionally provided by credit/liquidity facilities.
2. Specifically exclude CMBS advances similar to those described when referencing risk-weighting related to an undrawn portion of a facility.
3. Allow certain modifications to the eligible cash advance facility with respect to CMBS advances.
4. Provide that funded CMBS advances that meet the modified eligibility requirements are exempt from risk-weighting requirements.

Treatment of Other Comprehensive Income (OCI)

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[4] Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements, Federal Reserve p.79 (June 7, 2012).

The Regulatory Capital proposed rule on page 49 would require banks to include in regulatory capital unrealized gains and losses on available for sale (AFS) securities. Under existing GAAP, unrealized gains and losses on AFS securities are carried in the Other Comprehensive Income (OCI) category in the equity section of the balance sheet, but are specifically excluded from regulatory capital. This proposed change could give rise to significant volatility in regulatory capital since OCI can change dramatically even during the last hour of the last day of a quarter as a result of economic announcements happening near quarter end. Since AFS securities are, by definition, not held for sale it makes sense to continue to exclude unrealized gains and losses in OCI from the definition of regulatory capital.

Financing Independent Mortgage Companies

Independent mortgage companies finance loans held for sale with warehouse lines of credit and with repo financing.

MBA strongly believes conforming and/or FHA/VA residential mortgages should be included in the definition of financial collateral under the proposal. Particularly in the context of warehouse lending, conforming and/or FHA/VA residential mortgages are a readily accessible and uniquely liquid asset. The current business model of mortgage banking is dependent on a credit line whose affordability relies on the near-certain liquidity of the pre-sold underlying mortgages. The proposed risk-based capital treatment of warehouse lines will continue the current requirement to treat such lines as commercial loan exposures with no "look through" to the highly liquid collateral.

In addition, MBA recommends that the proposed rule be revised to allow reporting entities the option of looking through the repo structure to the financial collateral held therein, including the inclusion of residential mortgages in the definition of financial collateral.

Off-Balance Sheet Exposures

<u>Credit-Enhancing Representations and Warranties</u>

The Proposal requires the application of a 100 percent credit conversion factor (CCF) to credit-enhancing representations and warranties (reps & warranties). These reps and warranties generally have a limited life as in the case of early payment default clauses. Banks reserve for their exposures on these reps and warranties.

MBA recommends continuing the existing 120 days "safe harbor" for credit enhancing reps and warranties and removing the application of the CCF. Regulators can then perform periodic examinations of the adequacy of related reserves and reserve process as part of the regular examination. This approach will provide a more accurate and nuanced picture of the safety and soundness of an institution than using the blunt instrument contained in the proposed Credit Conversion Factor.

Recent events have provided an example of the cost banks will incur if the 120-day safe harbor is not retained. On September 11, 2012, the Federal Housing Finance Agency (FHFA), along with the government-sponsored enterprises (GSEs), announced a new representation and warranty framework for loans acquired by one of the GSEs. Included in this framework was an Automatic Repurchase Trigger, which will automatically initiate a repurchase demand if a borrower failed to make full payments on the mortgage for three months after the date the mortgage was acquired by the GSE. This appears to qualify as a credit-enhancing representation and warranty under the Proposal, and therefore would require capital be held for the full amount of the exposure.

In essence, banks will now be required to hold capital against a historically immaterial exposure, namely every newly originated mortgage that is sold to a GSE.[5] The capital cost, coupled with the administrative costs of reallocating capital to cover pipeline of newly originated loans, far outweigh the benefit of ensuring appropriate capitalization. Indeed, the current risk-based capital rules recognize this. MBA urges the Regulators to continue this valuable safe harbor.

Residential Mortgage Loans Sold With Recourse

The Proposal converts to an on-balance sheet credit equivalent residential mortgages that are sold with recourse, and applies to these exposures a 100 percent CCF. As a matter of practice, banking organizations already reserve capital on-balance sheet for both indemnified loans and loans sold with recourse in the form of reserves. MBA believes that the Proposal must allow for capital reserved against the converted exposure to be added into Tier 2 Capital as an Allowance for Loan and Lease Losses, as is currently the case for comparable on-balance sheet exposures and related allowances for credit losses. Such recognition would more accurately reflect the true capital position of the banking organization and avoid unnecessary penalties based on the form, rather than substance, of a transaction.

[5] Indeed, this risk should become even more immaterial, as tighter underwriting standards are implemented industry-wide.

II. Historical Perspectives and Economic and Market Impact

Layering of Regulations

The Proposal would add to a series of regulatory and market reactions to the recent financial crisis that would likely significantly curtail real estate lending by the banking sector. The net effect would be a reduction in stable, collateralized lending opportunities for banks; a reduction in funding for a critical sector of the economy; and a migration of assets with excessive capital charges from banks to other, investor groups that are not subject to these risk-based capital rules.

In response to the recession and financial crisis, a series of new standards and regulations have been adopted and/or proposed along a number of dimensions, all with the potential to reduce the supply of mortgage credit and collectively to prevent significant private capital to return to the real estate finance market:

- Tighter underwriting standards through a natural market assessment of the recent downturn and its implications for probabilities of default and losses given default;
- Tighter underwriting standards through ability to repay and other proposed regulations;
- Tighter securitization practices through a natural market review of performance and weaknesses during the recent credit crunch and downturn;
- Tighter securitization practices through risk retention and other recent requirements;
- More stringent ratings criteria;
- Tighter accounting standards, which have had the impact of bringing additional assets and liabilities onto the balance sheet;
- Increased compliance costs through additional disclosure requirements, other regulations, and heightened penalties for any violations.

This Proposal – to increase required capital for banking institutions of all sizes, notably for investment in mortgages or mortgage servicing assets – would be an additional, very impactful tightening of credit for real estate mortgages, and would in fact reduce the ability of the banking system both to prudently make loans collateralized by real estate and to serve as an important source of capital to the critical real estate sector of the economy that it has always served.

The pendulum has clearly swung too far, and regulators need to be very careful that they do not curtail the desire and ability of the banking system to hold and service mortgages at the very same time that the market is still recovering and federal housing policymakers would like to see private capital re-enter the market. Overweighting

capital costs for real estate lending by the banking system would drive this safe and sound investment opportunity to other capital providers – depriving banks of a key investment option and depriving real estate borrowers of a stable, secure source of funding.

The banking sector as a whole is one of the largest players in the mortgage market, and special care should be taken in contemplating any additional requirements that would further constrain the ability of banks to lend.

Recent Financial Crisis and the Role of Regulatory Capital Rules

Although academics will be debating this issue for decades, just as they are still debating the list of potential causes of the Great Depression, global and U.S. regulators have clearly opined that insufficient capital, i.e., excess leverage in the banking system, was a precipitating cause of the financial crisis in the fall of 2008. In particular, regulators have focused on the need to reduce leverage directly through more consistent application of leverage standards and by bringing contingent liabilities onto the balance sheet. In terms of risk-based capital requirements, efforts have been focused on increasing required capital on riskier assets, and encouraging (or requiring) banks to hold a buffer above stated requirements, by reducing the ability of banks to pay dividends to shareholders or bonuses to executives when capital levels dip below the buffer.

However, as mentioned above, regulators are taking a belt and suspenders approach to the problems that contributed to the crisis, taking actions to reduce risky assets directly, increasing the quality of capital by favoring tangible common equity capital over preferred stock and long-term debt, increasing the quantity of required capital, and defining the balance sheet more broadly by levying capital charges on off-balance sheet activities. Certain changes may well be necessary to increase the strength and resiliency of the banking system. However, going too far in the direction of tightening capital requirements has a cost, as history clearly shows.

Following the costly saving and loans crisis of the 1980s and banking crises around the world, regulators implemented the Basel 1 capital standards in the U.S. in the early 1990s in an effort to increase the safety and soundness of the banking system and to harmonize capital regulation, particularly for internationally active banks. Although not the sole factor, the increase in required bank capital, at a time when the financial system was trying to recover from a previous lending crisis, helped to cause a credit crunch – banks unable or unwilling to lend at prevailing rates due to binding capital constraints. Numerous authors have written on the importance of this channel, including the current Chairman of the Federal Reserve.[6]

Basel I began the effort of assigning different risk-weights to different assets. Banks were required to hold 8 percent risk-based capital to be considered adequately

[6] See Bernanke and Blinder (1988), Bernanke and Lown (1991), and Brinkmann and Horvitz (1995) for discussions of the credit channel.

capitalized and 10 percent to be well capitalized, and these risk-based requirements could be met with a combination of Tier 1 and Tier 2 capital. GSE debt and MBS received a 20 percent risk-weight (1.6 percent of required capital), whole loan residential mortgages received a 50 percent risk-weight (4 percent of required capital), while commercial and industrial loans received a 100 percent risk-weight (8 percent of required capital). Of importance to the mortgage market, these capital requirements were greater than the 2.5 percent capital requirements for Fannie Mae and Freddie Mac's on-balance sheet investments, and much higher than their 0.45 percent capital on their MBS guarantees. This created the potential for a capital arbitrage: banks could originate mortgages, which would have required 4 percent capital if they were held on balance sheet, and swap them for MBS, which required only 1.6 percent capital. Combined with the 0.45 percent capital held by Fannie or Freddie, the system as a whole held 2.05 percent vs. the 4 percent if they had stayed on banks' balance sheets, or 2.5 percent vs. 4 percent if the loans were held on the GSEs' balance sheet. Hence an unintended consequence of the regulation was to dramatically accelerate the growth of the GSEs once the system was established. However, in the interim, the result was a perceived shortage of capital among some banks, who cut back lending as a result.

This was not the only unintended consequence of this first Basel effort. There were other examples of capital arbitrage. Any asset for which the true economic risk was less than the required capital was likely to move out of the banking system. Assets for which the true risk exceeded the regulatory requirement were more likely to remain. Partly in response to this trend, Basel II was formulated to provide more granular risk-weights. However, the resulting increase in complexity of the regulation both lengthened the necessary time for implementation and raised the costs for impacted institutions. A strategy employed by the regulators was to offer/require this more complex regime to larger institutions that presumably had the capacity to model their own risks precisely, and in fact were required to calculate their own capital requirements under the supervision of their regulator, in exchange for lower total capital requirements. Smaller institutions were permitted to remain under the Basel I requirements. Research at the time of implementation indicated that this would accelerate the concentration of assets in the hands of the largest banks.[7]

During the crisis, it became apparent that the Basel II framework was insufficient. Investors were not interested in a bank's risk-based capital measure, they simply wanted to know how much of an equity cushion was available to absorb losses. The effort and cost that went into Basel II did little to protect the system when it was most needed.

Role of Banks in Real Estate Mortgage Finance

In proposing new regulatory capital rules, bank regulators need to consider the significant importance of the banking system to the overall real estate finance market. If the banking system pulls back from making new loans or is forced to shrink assets as a

[7] See Flannery, 2006

result of onerous capital requirements, the mortgage market and borrowers of all types will be harmed.

Banks and saving institutions ("depositories") play a major role in the single-family, multifamily, and commercial real estate markets. According to the FDIC, as of the first quarter of 2012, depositories had almost $14 trillion in total assets. Of these, there were $2.5 trillion of 1-4 family mortgages, roughly $1 trillion of commercial mortgages[i], and $220 billion in multifamily mortgages. In terms of market share, using the Federal Reserve's Flow of Funds data as a base, depositories accounted for 25 percent of 1-4 family mortgages, 27 percent of multifamily, and 48 percent of commercial mortgages. Depositories also held more than $1.7 trillion of mortgage-backed securities. A time series of each of these is shown in Appendix B, indicating that depositories have grown even more important to the mortgage market in recent years. Note that as a percent of total assets, 1-4 family mortgages are an important component across bank size classes.

Role of Banks in Mortgage Servicing

However, direct holdings of mortgage loans or securities are not the only, nor perhaps even the most important impact of the banking system on the mortgage market. Banks also service a large majority of securitized mortgages. As of the end of the first quarter of 2012, commercial banks held MSRs that totaled almost $45 billion, while saving institutions had MSRs valued at more than $3 billion. Assuming that a typical loan's servicing is valued at 100 bps, depositories are servicing about $4.8 trillion of mortgage loans.

As discussed in greater detail in this comment letter, the proposed treatment of MSRs under Basel III would be highly disruptive, as it would impose punitive requirements on MSRs that total more than 10 percent of Tier 1 capital. As with their total capital position, banks will want to maintain a buffer between their MSR value and this threshold to avoid this penalty. As a result, this provision would require many of the largest institutions to shed significant amounts of servicing, with no clear indication as to where it will go. Likely, that servicing would move to less regulated institutions.

Bank Capital Management

Banks, like other companies, fund themselves with equity and debt. What makes banks special is that roughly half of their debt funding is made up of deposits, most of which are federally insured. To help protect depositors, banks are heavily regulated with respect to their allowable activities, their management, and their leverage. Capital requirements are an important regulatory tool for managing the safety and soundness of banks.

A bank's equity capital is the loss absorbing component of their balance sheet – the difference between the value of the bank's assets and the bank's liabilities. There are multiple regulatory definitions of capital. Tier 1 capital is composed primarily of the par

value of common and preferred stock, and retained earnings. Tier 2 capital adds long-term debt and loss reserves.

The level of required capital is important for the structure of the banking industry. However, the change in required capital is more important in terms of the impact on the economy over the medium term. Raising capital requirements will necessarily create a drag on credit availability, even if the new constraint is not binding on all banks. The reason for this is that banks are already operating and managing their capital position with respect to current standards, and likely maintaining a buffer over these standards. If required capital is increased, banks will need to raise capital to return to their preferred buffer level. This is even more important if there are significant penalties for falling below a regulatory buffer zone.

Historically, many market participants, notably the credit rating agencies, have adjusted their views of corporate credit as regulatory capital guidelines have changed. Understandably, if there are regulatory penalties for falling below certain capital thresholds, and those penalties could be costly to the bank, it is sensible for the ratings criteria to be essentially a function of the capital buffer beyond the regulatory minimum. Thus market-based assessments interact and feed off of regulatory requirements. Regulators should understand that banks will not simply reduce dividends and increase retained earnings until they are in compliance with the new requirements. Banks will also restrict lending and conserve capital until they reach their desired surplus above the new requirements in order to minimize the chance that they would have to raise capital under distress.

To raise capital, banks can do three things either alone or, more likely in combination:

- Sell assets, i.e. reduce the size of the bank;
- Retain more earnings, e.g., reduce dividends to shareholders;
- Sell additional stock, i.e., dilute the value of existing investor's holdings.

If a bank pursues the first option, it is likely going to cut back on new lending. If it pursues options 2 or 3, its shares become a less attractive investment, making it more difficult and costly to raise additional capital. Investors in equity securities look across industries, meaning that banks have to compete not only with each other, but with other industries in attracting investors who are targeting a certain risk-adjusted return. If prospective returns are reduced, it becomes that much harder to raise capital. Without additional capital entering the industry, additional lending cannot be supported, regardless of how low interest rates are.

Implementation Timelines and Pro-active Behavior of Market Participants

Regulators have proposed a seemingly extended period before the Basel III requirements will be fully in effect. However, although these timelines are warranted given the complexity of the rule and the potential market disruptions that will result from compliance, even the potential for these rules has had an impact on the market. This could be clearly seen as some of the largest banks were regularly reporting their capital

levels relative to an assumed "Basel III" standards years before the standards were proposed. Likewise, investors were holding them to these standards and ranking institutions by their perceived strength as measured by these standards. Regulators need to understand that even the potential for such rules can have market impacts. Another example is the relative desirability of holding mortgage servicing. Servicing prime, performing loans is a business with considerable economies of scale, and many large banks had greatly increased their servicing portfolios prior to the crisis. Afterwards, partly in response to increased cost of servicing non-performing loans, and the increased regulatory burden that is part of servicing today, but also reflecting the potential penalty for having MSRs in excess of the 10 percent threshold, we have seen several large servicers either actively reduce their servicing books through sales, or reduce their origination volume to allow runoff. In several cases, large servicers have pared their origination volume by curtailing correspondent channels, thereby reducing secondary market outlets for smaller originators and decreasing the number and price of market bids for servicing.

Impact on the Mortgage Market from Basel III

The Proposal will impact the mortgage market along several dimensions:

- Increased capital requirements will reduce overall lending relative to the existing standards.
- Increased risk-weights for mortgage loans, particularly for loans with certain specified characteristics or features, will concentrate bank mortgage holdings in loans without these characteristics and concentrate loans with such characteristics in other capital sources.
- Penalties on MSRs above a 10 percent threshold could result in a major market disruption as servicing is dispersed from large holders to other institutions that may or may not have the capacity to economically service mortgages.

In addition to these global impacts, the new standards also have the potential to differentially impact the business models of small vs. large banks, mortgage specialists vs. non-mortgage specialists, and regional vs. national banks, etc. In contrast to the Basel II implementation which was focused on the largest banks in some ways providing them advantages in terms of lower required capital, but in other ways disadvantaging them with extra costs and burdens, the new proposal would impose higher capital requirements along with higher costs of compliance across the board. Thus it has the potential to have a negative impact on mortgage lending broadly, given the market share of the larger institutions, and impose higher costs of compliance on smaller institutions that likely already meet the level of capital required.

III. Mortgage Servicing Rights

Background on Mortgage Servicing: See attached Appendix A for information on the performance of servicing revenues and expenses.

Introduction

Under the Proposal, the following assets may receive only limited recognition when calculating the common equity component of Tier I capital, with recognition for each class of assets individually capped at 10 percent of the common equity component of Tier I capital:

- Significant investments in the common shares of unconsolidated financial institutions;
- Mortgage servicing rights; and
- Deferred tax assets that arise from timing differences.

In addition, under the Proposal, a bank must deduct the amount by which the aggregate of the three items above exceeds 15 percent of its common equity component of Tier I capital. In practice, this means that institutions will operate their businesses so that they will not hit this binding constraint given the cost and potential for disruption. Furthermore, they will likely operate with a buffer under this limit to avoid the possibility of having to deduct from their capital base.

This treatment would be a significant change to the treatment under existing U. S. regulatory capital rules. Presently, MSRs are limited to 50 percent of Tier I capital for banks and 100 percent for savings and loans, and there is no limitation on the combined total of the three asset classes. Thus, if a bank is at, above or approaching either the 10 percent or 15 percent thresholds, it would either stop producing or buying new servicing assets or price the underlying loans to take into account the deduction from capital.

It Doesn't Make Sense to Target MSRs

MBA believes that further restrictions on bank investments in MSRs makes little sense for the following reasons:

- Contractual servicing fees are paid at the top of the cash flow waterfall for Ginnie Mae MBS and most private label single family servicing. Servicing fees on Fannie Mae and Freddie Mac MBS are paid directly to the servicer by the GSE's. Targeting MSRs creates disparity between U.S. banks and foreign banks as the latter have few if any mortgage servicing rights.
- There is already a 10 percent haircut on MSRs in the U.S. regulatory capital rules. This coupled with the proposed 10 percent and 15 percent limits will put U.S. banks on an unlevel playing field compared with their foreign competitors.

- Unlike equity interests in unconsolidated financial institutions and deferred tax assets, servicing rights have contractual cash flows.
- Unlike equity interests in unconsolidated financial institutions and deferred tax assets, servicing rights are more marketable.
- MSRs are already treated as 100 percent risk-weighted assets (and 250 percent under the proposed rule).
- There are existing limitations on MSRs before they must be deducted from Tier I capital.
- Risks in holding residential MSRs are 1) prepayment risk (which the banks have demonstrated the ability to hedge effectively) and 2) risk of increased costs in servicing defaulted residential mortgages. In spite of the increase in defaulted mortgages during the recent crisis, MSRs performed reasonably well. See Appendix A for details.
- Commercial MSRs generally have little prepayment risk due to loan terms and receive increased servicing fees if a commercial mortgage goes into default.
- Servicing assets are a source of predictable deposits for banks and a primary relationship with banks' customer base.

Historical Context

The volume level and sophistication of the market for MSRs is unique to the U.S. This has evolved for a number of reasons. First, the roles of Fannie Mae, Freddie Mac and Ginnie Mae in creating homogeneous pools of loans with a government express or implied guarantee has fostered growth in the originate to sell market. There are no similar programs outside of the U.S. that have garnered the volume or level of sophistication that can compare to the programs and market in the U.S. Fannie Mae, Freddie Mac and Ginnie Mae have also played a major role in standardizing servicing processes and in establishing minimum servicing requirements and default processes through their respective seller/servicer guides.

Over the past twenty years, mortgage bankers developed the private-label securitization market to, in part, provide mortgage products to those borrowers or transactions that do not meet the requirements for pooling into Fannie Mae, Freddie Mac or Ginnie Mae securities such as jumbo loans.

Mortgage servicing in the United States has a developed secondary market for the acquisition or disposition of MSRs. Specialty brokers assist in connecting buyers and sellers, and standardized information tapes and due diligence procedures have been developed.

The two biggest risks in the ownership of residential MSRs are the risk of prepayment and increase in defaults. Financial institutions have proven to be quite successful in hedging prepayment risk through the use of various derivative instruments. Default risk is not subject to hedging. As defaults arise, servicers must increase staff to handle collection efforts, loss mitigation efforts, and foreclosures, and must advance principal

and interest for at least several months in most cases. Servicers include this added cost in valuations and in stress testing the MSR asset.

A third risk in residential mortgage loan servicing relates specifically to servicing for Fannie Mae and Freddie Mac. Under the Fannie Mae and Freddie Mac seller/servicer guides, seller representations and warranties legally attach to the MSR asset. If the MSRs are sold, seller representations become the obligation of the new servicer, unless they are specifically bifurcated. This risk became especially acute during the recent crisis. Since the crisis, Fannie Mae and Freddie Mac have retreated to less risky, plain vanilla products that require complete underwriting documentation. Thus, MBA expects that claims against servicers for more recent production vintages to be reduced. MBA also notes that the liability for such seller reps and warranties are not included in the valuation of the MSR. Rather, they are recorded in a separate reserve on the liability side of the balance sheet.

For commercial mortgage loans and CMBS MSRs, prepayment risk is much lower because of structural loan elements such as defeasance and yield maintenance that deter prepayment. Defeasance of a securitized commercial mortgage is a process in which a borrower substitutes other income-producing collateral (typically U.S. Treasuries) for a piece of real property to facilitate the removal of an existing lien without paying-off of the existing note. In this case, servicing fees are still received but float (i.e. interest paid on escrow accounts) and ancillary fees (late fees, loan modification fee, etc.) are not collected. Yield maintenance is a premium that a borrower pays when paying-off a loan prior to maturity that allows the lender or investor(s) to attain the same yield as if the borrower made all of the scheduled loan payments. Therefore, MSRs for commercial/multifamily mortgages should be excluded from the Proposal.

The valuation of residential MSRs has become quite sophisticated especially for banks that must include MSRs in their stress tests. There are a variety of MSR valuation models available, and there are a number of firms that specialize in providing independent MSR valuation services. In the case of residential MSRs there are even firms that specialize in forecasting prepayment speeds for use in the valuation of MSRs.

Accounting literature began recognizing the MSR asset in the United States starting in 1982 with FASB Statement 65, *Accounting for Certain Mortgage Banking Activities* (FAS 65). FAS 65 provided for the recognition of servicing rights as an intangible asset acquired in a business operation or in a purchase of mortgage loans if a definitive plan for the sale of the mortgage loans existed when the transaction was initiated. Later, FAS 122, *Accounting for Mortgage Servicing Rights* (FAS 122) extended the capitalization of servicing rights to mortgage loans originated for sale. This statement has been amended by subsequent FASB pronouncements including FAS 125, FAS 140 and FAS 166 all of which have been superseded by Accounting Standards Update (ASU) No. 2009-16, Transfers and Servicing (Topic 860). Topic 860 requires servicing assets to be initially recorded at fair value and allows servicing assets to be subsequently carried at either amortized cost or fair value. (NOTE: 860-50-25-1 only allows an entity to recognize a servicing asset or servicing liability if it has undertaken an obligation to

service a financial asset by entering into a servicing contract in one of two instances: 1) a servicer transfers financial assets from its balance sheet and the transfer meets the requirements for sale accounting; or 2) the servicer assumes or acquires a servicing obligation that does not relate to financial assets of the servicer or its consolidated financial statements being presented. A servicer that transfers or securitizes financial assets in a transaction that does not meet the requirements for sale accounting and is accounted for as a secured borrowing with the underlying financial assets remaining on the transferor's balance sheet shall not recognize a servicing asset or servicing liability.

Outside of the U.S. most mortgages have been originated for portfolio not for sale or securitization. Accounting pronouncements related to servicing assets have been limited in international accounting standards. The impact of the proposed deduction from Tier 1 equity would be minimal to most of the international bank regulators who voted in favor of it.

MBA believes that the prudential bank regulators in the U.S. should not follow Basel to define the capital treatment of MSRs in the U.S. Rather, MBA believes that the OCC, Fed and FDIC should act so that MSRs continue to be welcome assets in banks' portfolios with regulatory capital treatment properly set in accordance with the risk parameters of the asset. Particularly, treatment of MSRs should reflect the structure of each nation's mortgage and servicing markets. A one size fits all approach to MSRs in the Proposal would unnecessarily penalize depository institutions in the U.S., a system with a well established and efficiently functioning mortgage servicing industry.

Estimated Market Impact

Using data from first quarter 2012 call reports and thrift financial reports as summarized on the FDIC website, MBA estimates that 54 banks are already over the 10 percent cap. These banks represented roughly $16.5 billion in MSRs, approximately 40 percent of the aggregate MSR value across all banks. **If the 10 percent cap were binding today, about $3 billion of MSR value would need to be shed, which if valued at 100 bps, would represent an estimated $300 billion of mortgage debt outstanding would have to change hands.**

MBA has tracked this impact and noted significant quarterly changes. These quarterly changes highlight the volatility in the market value of the MSR asset (but not necessarily in the economic value or in the hedged value). Given this volatility, banks would likely want to keep a buffer between their MSR/capital ratio and the 10 percent limit. This would further impact the market. For example, if banks were to target a 7 percent ratio, we estimate roughly twice as many institutions would be constrained.

MBA notes that many banks are already scaling back MSRs and tightening their lending on residential mortgage loans. MSRs are selling at historic lows of from 90 to 100 bps of principal. If the rule is put in place and banks are forced to sell MSRs, these sales would be perceived to be "forced sales" by remaining market participants and the result would harm the value of remaining servicing rights on the balance sheets of banks and other servicers.

Statistics are not available on the FDIC website for deferred tax assets at the individual institution level, so MBA was unable to estimate the banks over the 15 percent limit on the aggregate of MSRs, deferred tax assets, and equity interest in unconsolidated financial institutions. Thus, even with the lengthy proposed transition period, there could be a significant market impact.

To summarize, adopting Proposal's limits on MSRs in the U.S could dramatically impact U.S. banks and servicing market. It would result in banks shedding a significant portion of servicing rights. It would also decrease banks' appetites for investing in additional mortgage servicing assets.

Impact on and Importance of Banks' Participating in Servicing

Most banks are sophisticated in the management of assets and liabilities. One of the key features of asset/liability management is the proper allocation of scarce resources. As a result of regulatory capital rules, a key scarce resource that banks consider in the asset/liability management process is the allocation of regulatory capital. In the allocation process, if an asset would be a direct deduction from capital, as proposed for MSRs under the proposed rule, it is likely:

- Banks may elect to allocate no additional capital if MSRs are close to or exceed 10 percent of the common equity portion of regulatory capital.
- Banks may elect to allocate no additional capital if the combination of MSRs, equity investments in unconsolidated subsidiaries, and deferred tax assets are close to or exceed 15 percent of the common equity portion of regulatory capital.
- Banks that are close to or exceed the 10 percent or 15 percent thresholds may also start to sell MSRs because MSRs are easier to monetize than deferred tax assets and equity interests in unconsolidated subsidiaries.
- Banks not yet close to the limits would likely require a higher return on MSRs due to the potential adverse regulatory capital treatment. This would likely reduce liquidity of servicing rights and ultimately increase pricing to the consumer.
- Banks above the limit will reduce new mortgage originations unless they have an ability to sells the newly created MSRs to others in the market. This reduction in production will result in a less competitive market and less credit availability for consumers.

Since a large percentage of mortgage loan production and securitization is done by depository institutions, the long-term impacts of the Proposal could include:

- Reduction in the percent of servicing performed by depository institutions.
- Reduction in the supply of mortgage credit.
- An increase in mortgage servicing in the hands of non-depositories.
- An increase in the cost of mortgage credit to consumers.

MBA points out that two of the principal relationships banks have with their customers are the deposit relationship and the mortgage relationship. Banks believe that there is synergy in having customers with multiple relationships in terms of customer retention

and ability to cross-sell fee for services relationships to improve bank profitability. Once a bank sells the servicing related to the mortgage relationship, the synergy with the customer is significantly reduced.

Another value of MSRs is the float benefit that inures to the servicer in the form of escrow deposits for payment of property taxes and insurance and principal and interest collected awaiting monthly pass-through to MBS holders. A bank can better realize such float benefits than a non-depository.

If a bank continues to originate loans for sale and sells the resulting MSR, this will add confusion to the consumer as servicing is churned.

Servicing is a fiduciary role. Banks are highly experienced in acting in a fiduciary role to protect and account for trust assets.

Impact of Non-depositories Picking Up More Servicing

There are many good servicers that are not depository institutions. They are experienced and can do a good job servicing mortgages. However, there are some things that the prudential bank regulators should consider in deciding whether to adopt the Proposals limits on servicing which may result in the shift of a large portion of servicing activities to non-banks:

- Generally, banks are more highly regulated than non-depositories, providing more regulatory scrutiny of the fiduciary functions associated with servicing. Bank regulators even have specific examination procedures for servicing assets and operations, and those procedures have been bolstered during the recent mortgage crisis.
- Many mortgage backed securities serviced require the servicer to pass-through to MBS holders scheduled principal and interest. Similarly, servicers normally are required to pay real estate tax, mortgage insurance and hazard insurance bills frequently before adequate funds are in escrow from the borrower. Generally, banks have more liquidity available to fund the associated advances.

Existing Automatic 10 Percent Haircut

The 10 percent and 15 percent limits are in addition to the current 10 percent haircut that arose from the FDIC Improvement Act of 1991.

Under present rules the effective capital that must be retained for MSRs is 17.2 percent as follows:

- Assume 8 percent minimum capital requirement to be adequately capitalized.
- 10 percent of the value is deducted and the remaining 90 percent is risk-weighted at 100 percent.
- This equates to a minimum capital requirement for MSRs of 17.2 percent (10 percent plus (90 percent times 8 percent)).

Under the proposed rules, the required capital that would have to be maintained, not considering the 10 percent and 15 percent proposed limits, would be a whopping 28 percent as follows:

- Assume 8 percent minimum capital requirement to be adequately capitalized.
- 10 percent of the value is deducted and the remaining 90 percent is risk-weighted at 250 percent.
- This equates to a minimum capital requirement of MSRs of 28 percent (10 percent plus (90 percent times 20 percent)).

This would increase required capital for MSRs by 63 percent, without taking into consideration the 10 percent and 15 percent limitations in the proposed rule. If the Basel III 10 percent or 15 percent thresholds are breached, the minimum capital requirements skyrocket. Since foreign banks are not subject to the 10 percent haircut, it puts U.S. banks on an unlevel playing field. This is contrary to the purpose of the Basel rules which is to put banks worldwide on a level playing field with respect to regulatory capital requirements.

Recommendations to Consider

MBA believes that existing regulatory capital treatment of MSRs is appropriate, and the Basel III limits on MSRs should not be adopted in the U.S. If, however, U.S. bank regulators move forward with the proposed treatment, MBA recommends that its impact be reduced in order to ensure that the mortgage market is not adversely impacted. MBA specifically recommends:

- Reduce the existing haircut under the FDIC Improvement Act of 1991(the Act) to 0 percent, as allowed under the Act. This would put U.S. banks on a level playing field with other banks, prior to implementation of proposed MSR restrictions.
- The MSR cap before deduction from the common equity component should be raised to a higher level. MBA recommends the use of at least a 25 percent cap for MSRs on the books of commercial banks. The present capital rules allow depositories with a thrift charter a higher threshold than those with a bank charter in order to further promote mortgage lending by savings and loan associations. Basel III should continue to recognize this important differential in its limits of MSRs. MBA therefore recommends a 50 percent cap for MSRs on the books of thrifts and savings and loans.
- MSRs should not be included in the 15 percent cap.
- Servicing of commercial mortgages and MBS should be carved out completely from the application of the Basel III limits on servicing because of the reduced prepayment risk and the fact that servicing fees are received on assets in default.

MBA also recommends that U.S. bank regulators consider the other alternatives to minimize the market and consumer impacts of the proposed rules:

- MSRs existing as of the date of enactment should be "grand-fathered" and not subject to the limitations under the Basel Annex.

- Measurement of residential MSRs for purposes of the 10 percent and 15 percent limits in the Basel III proposed rules should be limited to the unhedged value of the MSRs.
- Have a more favorable limitation for government and agency servicing than for private-label mortgage servicing.
- In servicing loans for Fannie Mae and Freddie Mac, the seller representations and warranties attach to the servicing rights. The Fannie Mae guide states:

> When Fannie Mae consents to a transfer of servicing by a lender, it relies on the integration and non-divisibility of the Contract. Fannie Mae requires that the transferor or lender remain obligated for all selling representations and warranties and recourse obligations upon the transfer of servicing, and requires that the transferee servicer, whether the original seller or a transferee servicer, undertake and assume joint and several liability for all selling representations and warranties and recourse obligations related to the loans it services unless explicitly agreed to the contrary in writing by Fannie Mae. [8]

The seller of a loan must record a liability for seller representations and warranties. Since Fannie Mae and Freddie Mac make the servicer undertake a joint and several liability for seller representations and warranties, the liability recorded for Fannie Mae and Freddie Mac reps and warranties could be deemed to relate to the MSR. MBA, therefore, recommends that in drafting any rules related to the Basel III limit on servicing, the bank regulators should allow for a reserve offset in situations where the seller warranties attach to the MSR asset.

In its letters to the prudential regulators dated April 29, 2011, MBA recommended that deferred tax liabilities related to the tax safe harbor for MSRs be used to reduce MSRs for purposes of calculating the 10 percent and 15 percent limits. The Proposal does include such deferred tax liability offset, and MBA greatly appreciates the Regulators' inclusion of this suggested treatment in the proposed rule.

Possible Deduction of MSRs from Capital Under Proposed Securitization Exposure

Page 66 of the proposed Regulatory Capital Rules document states:

> A banking organization would deduct from common equity tier 1 capital elements any after-tax gain-on-sale associated with a securitization exposure. Under this proposal, gain-on-sale means an increase in the equity capital of a banking organization resulting from the consummation or issuance of a securitization (other than an increase in equity capital resulting from the banking organization's receipt of cash in connection with a securitization).

A securitization exposure is the issuance of a securitization that contains more than one risk tranche. It would exclude Ginnie Mae, Fannie Mae and Freddie Mac MBS, but would include most private-label MBS which contain multiple risk tranches.

Non-cash proceeds from MBS often retained by the securitizer include master servicing rights and servicing rights. From the wording of the Proposal it appears that servicing

[8] Selling Guide, Fannie Mae, Part A, Subpart 2, Chapter 1.

rights would be subject to not only the 10 percent and 15 percent limitations discussed above, but may get deducted from capital anyhow as gain-on-sale from a securitization interest. If we are reading this correctly, the vast majority of MSR assets that are not related to Ginnie Mae, Fannie Mae and Freddie Mac would be deducted from equity.

One of the Obama administration's stated objectives is to bring private capital back to the mortgage market. This deduction of gain-on-sale from capital on securitization positions will likely ensure that banks will not be part of that private market capital. In addition, many banks will likely scramble to rid their balance sheets of non-government or agency servicing prior to the effective date of Basel III. This will place more of the private-label securitization servicing in less regulated segments of the industry.

To the extent that a bank remains in the private label securitization business, it will be forced to raise interest rates to consumers such that the after tax ***cash-based*** gain-on-sale will make up for the regulatory capital consumed by the proposed capital deduction of MSRs and other non-cash interests retained. This will result in a larger adverse spread between the pricing of non-conforming mortgages to loans eligible for Ginnie Mae, Fannie Mae, and Freddie Mac MBS and resulting adverse impact on consumer pricing.

Risk-Weights of MSRs Not Deducted from Capital

Presently, MSRs are treated as 100 percent risk-weight[9] assets. Under the proposed rules, MSR assets would be treated as 250 percent risk-weight assets. MBA believes that increases on the risk-weight of bank investments in MSRs makes little sense for the following reasons:

- Servicing rights have contractual cash flows that are relatively stable and easy to project. They represent senior liens on the cash flows of principal and interest on the underlying mortgages being serviced.
- Servicing rights are readily marketable and are therefore more liquid in nature than many assets otherwise rated below the proposed 250 percent risk-weight.
- The largest single risk in holding residential MSRs relates to prepayment risk. Banks have demonstrated the ability to hedge most of this risk.
- Commercial MBS generally have little prepayment risk.
- Servicing assets are a source of predictable deposits for banks and a primary relationship with banks' customer base.

The value of MSRs generally is based upon discounting projected cash flows. Likely, the discount rate would increase as a result of the increase in required regulatory capital to support the asset. This would likely be passed on to the consumer in the form of

[9] "Risk-weight" and "risk-weighted" will be used interchangeable throughout this submittal. These terms represent the percent of regulatory capital (8 percent in the case of structured securities) that a bank must hold for given asset. Therefore, a structured security with a 50 percent risk-weight or risk-weighted, would have a 4 percent capital charge (50 percent x 8 percent). These terms are not interchangeable with "risk-weighting" that represents the capital charge as a percentage of the asset value. A 50 percent risk-weighting would translate into a 50 percent capital charge or $500,000 in the case of a $1,000,000 asset.

higher pricing. This would be separate from the possible increases in rates charged to consumers based upon the potential deduction from the common equity component of Tier 1 capital of MSRs as discussed above and the impact on interest rates charged because of the proposed adverse treatment of certain advances discussed more fully below.

MBA believes the existing 100 percent risk-weight is appropriate in the circumstances and should not be changed.

Treatment of Servicing Advances

Page 79 of the Proposal's Standardized Approach (Standardized Approach) addresses servicing advances of principal and interest on securitization positions. Unless the servicing advance is an eligible servicer advance, it must be risk-weighted at 1,250 percent. This has the same impact as deducting the advance directly from capital.

An eligible servicer advance is one in which the servicer is entitled to full reimbursement of the advance (except for contractually limited, insignificant amounts of outstanding principal), the servicer's right to reimbursement is senior in the right of payment to all other claims on the cash flows, and the servicer has no legal obligation to advance if the advances are unlikely to be repaid.

Page 72 of the Standardized Approach carves out Ginnie Mae, Fannie Mae and Freddie Mac exposures from consideration in the securitization exposure section because those securities do not have multiple tranches. Thus, the impact of this portion of the Proposal would be on private-label securitizations including many commercial MBS and private label securitizations of jumbo and non-conforming prime single family loans. If you look at the cumulative impact of the 10 percent and 15 percent limitations on servicing, the increase in risk-weight of MSRs from 100 percent to 250 percent, and now the 1,250 percent risk-weight of certain contractual advances, MBA suspects many banks will exit the servicing business, especially servicing of loans that are not part of Ginnie Mae, Fannie Mae or Freddie Mac MBS, or, at a minimum increase the pricing to consumers and small businesses, in the case of commercial real estate mortgages.

MBA points out that to the extent all or a portion of an advance is deemed uncollectable; the servicer is required under GAAP to reserve or charge-off the uncollectable asset. MBA believes that the proposed risk-weighting of advances is unduly onerous and punitive.

IV. Residential Mortgages

Introduction

The Proposal contains several changes to existing risk-based capital rules that are likely to have a significant and negative impact on the residential mortgage market. These are:

- The proposed risk-weights of residential mortgages differs markedly from the standards adopted by the European Union (EU);
- The proposed definition of Category 1 mortgages does not reference the imminent Qualified Mortgage (QM) criteria;
- High proposed risk-weights for Category 2 mortgages and a possible "cliff effect";
- The proposed exclusion of private mortgage guarantee insurance (MI) as a legitimate credit enhancement;
- Proposed risk-weights of HELOCs and other junior lien exposures that are beyond the inherent risks.

These issues are addressed below.

The Proposed Risk-Weight of Residential Mortgages Differs Markedly From the Standards Adopted by the European Union

Under present rules, FHA and VA loans are risk-weighted zero percent, and most other residential mortgage loans are risk-weighted 50 percent. The maximum risk-weight for any residential mortgage exposure is 100 percent.

The Proposal would continue to risk-weight FHA and VA loans at zero percent, but would introduce a new classification system for other residential mortgage exposures. Other mortgage exposures would either be classified as Category 1 or Category 2 mortgages.[10] Among other criteria, a Category 1 mortgage must have a term of 30 years or less, payment terms must not result in an increase or deferral of principal and the lender must demonstrate that the borrower has the ability to repay the loan.[11] All mortgages not meeting the Category 1 criteria are Category 2 mortgages. The primary impact of classifying a mortgage as Category 1 as opposed to Category 2 is significantly lower risk-weighting for loans of comparable LTVs, as shown in the following chart.

[10] Standardized Approach, pg. 29-30.
[11] For the full criteria, *see id.*

*Table 2 – Comparison of Category 1 v. Category 2 Mortgages

LTV	Category 1	Category 2
Less than or equal to 60 percent	35%	100%
Greater than 60 percent but less than or equal to 80 percent	50%	100%
Greater than 80 percent but less than or equal to 90 percent	75%	150%
Greater than 90 percent	100%	200%

MBA notes that Basel III as adopted by the European Commission does not stratify residential mortgage loans into different categories. Thus, the Regulators have proposed more onerous standards for domestic banks than those imposed on foreign banks, placing U.S. banks at a competitive disadvantage. The average risk-weight of mortgages is currently 15 percent in Asia and 14 percent in Europe under existing risk-based capital rules,[12] whereas the average risk-weight of mortgages in the U.S. is 40 percent.

The Proposal will further widen this disparity. Under the European Commission proposal, an exposure "fully and completely secured by mortgages on a residential property which is or shall be occupied or let by the owner, or the beneficial owner in the case of personal investment companies, shall be assigned a risk-weight of 35 percent."[13] This compares to the proposed range of from 35 percent to 200 percent under the Proposal. MBA notes the fundamental premise of the Basel Commission was to achieve regulatory parity among internationally active financial institutions, and the proposed treatment of residential mortgages runs counter to this premise. MBA recommends that the U.S. regulators eliminate the proposed new mortgage categories and align proposed risk-weights with other Basel nations.

The Proposed Definition of Category 1 Mortgages Does Not Reference the Imminent QM Criteria

According to the Regulators, the purpose behind the Proposal's classification system is to appropriately weigh the credit risk for a particular loan by identifying the terms most closely connected to a mortgage's riskiness.

The Dodd-Frank Act requires that all residential mortgages be subject to nationwide ability to repay standards, and the Consumer Financial Protection Bureau (CFPB) is expected to finalize rules under this provision of Dodd-Frank early in 2013. Since all

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[12] Le Lesle' and Avramova, *Revisiting Risk-Weighted Assets: Why Do RWA's Differ Across Countries and What Can Be Done About It?,* International Monetary Fund, March 2012.
[13] European Commission, *Proposal for a Regulation of the European Parliament and of the Council*, July 7, 2011.

loans must meet ability to repay standards and that is the key point to define Category 1 loans, it makes sense that virtually all U.S. residential loans should be deemed to be Category 1 mortgages.

Similarly, MBA believes that seasoned loans that are performing already demonstrate the ability to repay, and thus should be "grandfathered" as Category 1 loans. Additionally, loans underwritten since the summer of 2010 have been underwritten and documented with the Dodd-Frank Act requirement of ability to repay in mind. Thus, MBA recommends that unseasoned loans likewise be "grandfathered" as Category 1 loans unless there is evidence of early payment default relating to circumstances that existed at the date the loan was underwritten.

High Risk-Weights and Cliff Effect

The proposed risk-weights for Category 2 loans are intended as a reaction to the sizable and unexpected losses in the wake of the rapid deflation of the housing market in 2007 and 2008. MBA cautions against establishing standards based on activities during these years because such activity is so remotely different from historical norms. This could result in some harsh, unintended consequences, including the inability of first time homebuyers to qualify for a loan and risk spreads on Category 2 loans well in excess of the true risk differential resulting in unwarranted price differentials to consumers.

MBA recommends that the risk-weight for Category 2 loans be reduced to a range from 50 percent to 150 percent. Further, MBA is concerned that limiting the LTV tranches to only four tranches will potentially result in a "cliff effect" when mortgages shift between categories. Accordingly, MBA recommends that the number of LTV tranches be expanded to at least six tranches.

The Proposed Exclusion of Private Mortgage Insurance as a Legitimate Credit Enhancement

Under the Proposal, the risk-weight of a particular mortgage is dependent upon the LTV calculation. However, the Proposal excludes loan level MI from this calculation. The Regulators state that the "varying degree[s] of financial strength of mortgage insurance providers" justifies this provision.

When backed by a strong counterparty, MI significantly reduces loss severity.[14] MBA supports efforts to ensure MI providers are strongly capitalized and well regulated; such information would be a valuable market tool and could contribute to accurate and fair risk-weights. However, fully discounting the value MI provides is not the solution, nor are the higher prices that will inevitably result if the Proposal is enacted unchanged.

The primary effect of the Proposal's exclusion of MI from LTV calculations will be to shift additional costs onto prospective home buyers. Moreover, because of their zero

[14] *See, e.g., Global Criteria for Lenders' Mortgage Insurance in RMBS*, Fitch Ratings, August 3, 2012.

percent risk-weight, FHA loans will be given a tremendous advantage in the marketplace, and may in fact become the new standard as banks decide to minimize capital usage. The Regulators should strongly consider whether this is appropriate or desirable.

Excluding MI from the LTV calculation is not only the wrong approach, it is counter-productive. Far from clarifying risk, it will shift costs onto borrowers while introducing unpredictable risks to credit-enhancement valuation. Finally, the Proposal will result in much higher pricing to consumers, especially first home buyers who do not have significant equity to invest in their home.

Home Equity Lines of Credit

Under the Proposal, a bank may classify a junior lien as a first lien, Category 1 mortgage only if the bank holds both the first and the junior lien on the same property, no other party holds an intervening lien, and the terms and characteristics of both mortgages meet all of the requirements for a Category 1 mortgage. All other junior liens are classified as Category 2 mortgage exposures. This marked change will impair the housing recovery by imposing significant costs on both borrowers and lenders. Additionally, the treatment of stand-alone junior liens in general requires capital to be held twice against the same exposure, an onerous approach that will significantly impact the market.

The Proposal provides that, "[i]f a banking organization holds two or more mortgage loans on the same residential property, and one of the loans is Category 2, then the banking organization would be required to treat all of the loans on the property as Category 2."[15] This treatment is inconsistent with the actual risk profile of these loans.

First, the Proposal fails to explain why a junior lien mortgage extended by the same institution holding the first lien mortgage on the same property has the potential of dramatically increasing the risk of the exposure, yet there would be no impact if a third-party institution extended the second mortgage.

Additionally, borrowers often obtain home equity lines of credit from the same lender that provided the borrower a first mortgage on the property. Under the Proposal, banks would be reluctant to extend a home equity loan or home equity line of credit to these customers because making such loans would cause their Category 1 first mortgages with low risk-weights to shift to Category 2 mortgages with substantially higher risk-weights. Instead, first mortgage customers would be driven to different banks to obtain their home equity loans and lines of credit. This unusual treatment is unwarranted, and certainly does not reflect a meaningful difference in risk. Indeed, it is less risky for a lender that already understands the creditworthiness of a first lien customer to extend a junior lien loan to that customer, as opposed to a third party lender who would need to begin the underwriting process from scratch.[16]

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[15] Standardized Approach NPR, at 125.
[16] Not to mention the added cost to the borrower in reproducing the required information.

Accordingly, the first lien and junior lien loans should be evaluated independently, based on the different risks of each, and not aggregated into a single loan for risk-weight purposes. The terms of a junior lien should not cause the senior lien on the same property to fall into Category 2.

Further, the proposed treatment of a stand-alone junior lien mortgage is onerous. Page 125 of the Standardized Approach states:

> For a junior-lien mortgage, the loan amount would be the maximum contractual principal amount of the loan plus the maximum contractual principal amounts of all more senior loans secured by the same residential property on the date of origination of the junior-lien residential mortgage.

Thus, if a bank held a $10,000 junior-lien mortgage, and another financial institution held a $150,000 first lien, the bank holding the junior lien would have to hold capital on the total of $160,000 and the bank holding the first lien would hold capital for only their exposure of $150,000. The risk-weighting of the junior lien would be substantially different than the actual risk, and two banks would end up holding capital for the same exposure!

MBA recommends that bank regulators not require risk-based capital be held on an off-balance sheet senior lien not owned by the reporting bank.

V. Multifamily and Commercial Real Estate Mortgages

Multifamily Mortgages

For statutory multifamily mortgages ("statutory mortgages"), the Proposal calls for the risk-weight to remain at 50 percent. In order to be classified as a statutory mortgage, it must meet the requirements of section 618(b)(1) of the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991 (RTCRRIA).[17] As shown in Appendix F, the underwriting requirements for statutory mortgages are identical to the underwriting requirements for a 50 percent risk-weight in the Proposal. In addition, the Proposal's loan requirements for a 50 percent risk-weight are in conformance with section 618(b)(1) of the RTCRRIA.

By maintaining the existing loan qualification requirements for the 50 percent risk-weight for multifamily mortgages, the Proposal avoids creating unintended consequences that could potentially occur if the loan qualification requirements would have been materially changed. This will preserve the competitive balance for bank multifamily lending.

Commercial Real Estate Mortgages

Performing Commercial Real Estate Mortgages

For non-multifamily performing commercial real estate, the Proposal maintains the existing 100 percent risk-weight. While we agree that performing commercial mortgages did not merit consideration for increased risk-weight, we point to the approach taken by the European Commission[18] for U.S. regulators to emulate. The European Commission has adopted a 50 percent risk-weight for commercial mortgages that meet the following conditions:

> The 50% risk-weight unless otherwise provided under Article 119(2) shall be assigned to the part of the loan that does not exceed 50% of the market value of the property or 60% of the mortgage lending value unless otherwise provided under Article 119(2) of the property in question in those Member States that have laid down rigorous criteria for the assessment of the mortgage lending value in statutory or regulatory provisions.[19]

As indicated in Appendix F, in to order qualify for the 50 percent risk-weight, a multifamily mortgage must meet a significant series of underwriting requirements,

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[17] P.L. 102-233. Requirements for a statutory multifamily mortgage are shown in Appendix F and include requirements such as an 80 percent or less loan-to-value and a debt services of no less than 120 percent.

[18] The European Commission represents the interests of the European Union as a whole. It proposes new legislation to the European Parliament and the Council of the European Union, and it ensures that European Union law is correctly applied by member countries. See http://ec.europa.eu/atwork/index_en.htm

[19] Proposal for a Regulation of the European Parliament and of the Council On Prudential Requirements for Credit Institutions and Investment Firms Part I, European Commission, p.126 (February 2, 2012).

whereas the European Commission approach focuses on loan–to-value (LTV) percent or percent of the mortgage lending value. MBA considers the statutory mortgage approach to be more comprehensive and, as a result, a more credible method for identifying mortgages that merit reduced risk-based capital than the methodology employed by the European Commission.

Along these lines, we believe that the European Commission's concept for a reduced risk-weight for commercial mortgages that meet certain conditions should be implemented by U.S. regulators for non-multifamily commercial mortgages. This would allow the concept of a statutory mortgage to be expanded to non-multifamily commercial mortgages. The underwriting parameters for the statutory multifamily mortgage (see Appendix F) should be the starting point for defining a 50 percent risk-weight commercial loan.

In fact, Congress contemplated a similar concept when it drafted the Dodd-Frank Act.[20] It has a provision that directed the regulatory agencies to consider reducing the five percent risk retention required for CMBS if "a determination by the Federal banking agencies and the Commission that the underwriting standards and controls for the asset are adequate."[21] A statutory commercial mortgage, in the context of risk retention, was intended by Congress and is consistent with MBA's recommendation that well underwritten commercial mortgages should be strongly considered for reduced risk-based capital treatment by Regulators.

Such an approach would allow U.S. banks to maintain risk-based capital parity with their EU[22] counterparts for commercial mortgages. We are concerned that a higher risk-based capital charge for U.S. bank holdings of commercial mortgages may influence capital allocation decisions.

High Volatility Commercial Real Estate Loans

The Proposal also addresses acquisition, construction, and development loans (ADC loans). Regarding the Regulators consideration of an enhanced risk-weight for ADC loans, we believe that this is the appropriate focus for the Proposal because of the challenges that some newly constructed commercial real estate projects experienced during the recent economic downturn.

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[20] Public Law 111-203, 124 Stat. 1376-2223 (July 21, 2010).
[21] Public Law 111-203, 124 Stat. at 1892 (July 21, 2010).
[22] The EU is a unique economic and political partnership between 27 European countries that together cover much of the continent. It was created in the aftermath of the Second World War. The first steps were to foster economic cooperation: the idea being that countries who trade with one another become economically interdependent and so more likely to avoid conflict. Since then, the EU has developed into a huge single market with the euro as its common currency. What began as a purely economic union has evolved into an organization spanning all policy areas, from development aid to environment.
See http://europa.eu/about-eu/basic-information/index_en.htm

The Proposal introduces a new risk-based capital category for commercial mortgages that qualify as a High Volatility Commercial Real Estate Exposures (HVCRE). The risk-weight increases from 100 percent to 150 percent for HVCRE loans. In the Proposal, the definition of an HVCRE is a credit facility that finances or has financed the ADC of real property, unless the facility finances:

> (1) One- to four-family residential property; or
> (2) Commercial real estate projects in which:
>
> (i) The LTV ratio is less than or equal to the applicable maximum supervisory LTV ratio in the agencies' real estate lending standards;
> (ii) The borrower has contributed capital to the project in the form of cash or unencumbered readily marketable assets (or has paid development expenses out-of-pocket) of at least 15 percent of the real estate's appraised "as completed" value; and
> (iii) The borrower contributed the amount of capital required under paragraph 2(ii) of this definition before the banking organization advances funds under the credit facility, and the capital contributed by the borrower, or internally generated by the project, is contractually required to remain in the project throughout the life of the project. The life of a project concludes only when the credit facility is converted to permanent financing or is sold or paid in full. A commercial real estate loan that is not an HVCRE exposure would be treated as a corporate exposure.[23]

In the case of ADC loans, the maximum applicable supervisory LTV ratio is 80 percent.[24] However, if the LTV ratio is less than 80 percent, a loan would not be classified as a HVCRE if the borrower had contributed 15 percent of the completed value of the project in either cash or readily marketable assets. Essentially, borrowers that contribute 15 percent or more in capital or have a LTV ratio of 80 percent or less will not have their ADC loans classified as a HVCRE.

MBA is of the view that the 80 percent or less LTV requirement or, in the absence of the 80 percent LTV requirement being met, the 15 percent borrower capital contribution requirement represents a prudent and reasoned approach for classifying construction loans that fall outside of the HVCRE definition and the 150 percent risk-weight is appropriate for HVCRE loans. However, we believe an area of the Proposal that would benefit from additional refinement is the calibration of the 15 percent capital contribution requirement for a 100 percent risk-weight.

In order to reduce their development cost basis, borrowers will sometimes enter into a contract with the land owners to have their land contributed to the project at a price below fair market value (appraised value). This arrangement is made with property owners in a variety of ways that may include: (1) the property owner receives a set percentage of the borrower's profits upon project sale; (2) the property owner is provided an equity or partnership interest in the property; and, (3) the property owner is paid back the price differential with interest once the property has been sold or received permanent financing.

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[23] Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements, Federal Reserve p.126, (June 7, 2012).
[24] 12 C.F.R Section 365.2, Real Estate Lending Standards.

HVCRE Recommendations

The difference between the contributed cost and fair market value of the property reduces development costs. However, the 15 percent required capital contribution for the 100 percent risk-weight only takes into account contributed capital, unencumbered readily marketable assets, and development expenses. Contributed property at below fair market value would not be included in any of these categories. By excluding property contributed at below fair market value in the 15 percent capital requirement, some viable projects may not be funded because they would unnecessarily be stigmatized as a HVCRE loan.

Another approach for allowing the property contributed below market value to be counted toward the 15 percent capital requirement for a 100 percent risk-weight can be found in (2)(iii) of the HVCRE definition on the prior page that indicates that before a bank can advance funding for a project "capital contributed by the borrower, or internally generated by the project" must stay with the project until the construction loan is paid off. The value of the property that is contributed at below market value could be classified as internally generated contributed capital to the project, which would allow it to be included in the 15 percent capital requirement for a100 percent a risk-weight. Alternatively, the (2)(iii) language could be expanded to include the following: "capital internally generated by the project *and the difference between the fair market value of the property and its contributed price*"(new language in italics). In addition, tax credits for low income multifamily housing should also be included in the definition of internally generated capital.

Since the HVCRE is a new risk-weight category, banks may view it as high risk lending signal to bank examiners. Thus, banks may be especially reluctant to make loans that fall into this category. Therefore, we strongly urge the Regulators to allow property contributed at below fair market value to be included in the 15 percent capital contribution test in order to avoid the unwarranted inclusion of worthy development projects in the HVCRE category.

VI. Securitization Exposures

Introduction

- The proposed treatment of private-label securitizations is excessive along a number of dimensions. If a policy goal is to increase private capital's role in the market, this proposal will be counter to that goal.
- The Dodd-Frank Act does limit the ability of regulators to use NRSRO credit ratings. However, the alternatives in the Proposal fall short and will constrict the availability of credit.
- MBA recommends that the Regulators recalibrate the SSFA in a manner that will allow it to more closely approximate the risk-weights of competing European Union financial institutions.
- Until the SSFA has been recalibrated, MBA strongly recommends that the existing ratings-based risk-weight approach remain in place.

A significant departure of the U.S. Proposal from the EU's version of Basel III is the exclusion of credit ratings in determining risked-based capital for structured securities. This was prompted by section 939A of the Dodd-Frank Act[25] that required all federal agencies to remove references to and requirements of reliance on credit ratings from their regulations and replace them with appropriate alternatives for evaluating creditworthiness.

MBA appreciates the Regulators consideration of a range of options prior to presenting its proposed replacement for reliance on credit ratings. Under the Proposal, the Regulators have offered three alternatives to the ratings-based approach: (1) the 1,250 percent risk-weight; (2) SSFA; and, (3) the gross-up approach. In evaluating these options, MBA relied on a set of risk-based capital principles that were developed in a prior MBA comment letter.[26] The principles are shown in Appendix G.

For banks not implementing the SSFA or gross-up approach, a 1,250 percent risk-weight will be assigned to their holdings of structured securities. This translates in a dollar-for-dollar risk-based capital charge. The SSFA methodology, among other things, heavily factors the subordination level of the structured security position and recent performance history of the structured security in calculating risk-weights. The gross-up approach generates risk-weights based primarily on the amount of credit enhancement that the structured security position provides the tranches above it. The mechanics of these risk-weight methodologies will be further examined in the SSFA and gross-up approach sections.

MBA notes that the 1,250 percent risk-weight will be applied if a bank is unable to demonstrate a "comprehensive understanding of the features of a securitization

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[25] Public Law 111-203, 124 Stat. 1376-2223 (July 21, 2010).
[26] See MBA comment letter: Risk-Based Capital Guidelines: Market Risk; Alternatives to Credit Ratings for Debt and Securitization Positions – Docket ID OCC-2010-0003; Docket No. R-[1401]; FDIC RIN 3064-AD70, page 3, (Febuary 3, 2012).

exposure that would materially affect the performance of the exposure."[27] Consequently, banks electing the SSFA or gross-up approach risk-weight methodologies will be required to have a 1,250 percent risk-weight if they are unable to meet this requirement.

In addition, MBA is concerned that, under certain conditions, banks may be required to assign a risk-based capital charge to a structured security position that exceeds 100 percent of its value. MBA strongly recommends that the Final Rule limit the maximum risk-based capital charge to 100 percent of asset value.

We first address the relevant provisions of the Dodd-Frank Act that should guide the scope of this rulemaking. Additionally, we address an element of the Proposal where the Regulators indicate that the new capital requirements are intended to be similar to the Basel framework. This is followed by our analysis of the SSFA structure and the gross-up approach structure. We then analyze the risk-weight using a 2006 and 2012 representative CMBS issuances for the SSFA, the gross-up approach, and the 1,250 percent risk-weight as well as the EU and U.S. ratings-based approach. From this analytical effort, we will offer our conclusions and recommendations regarding the SSFA. Finally, we will address our strong concerns about the Proposal's due diligence requirements for structured securities.

MBA notes throughout this section where discrepancies between the Proposal and the Basel framework exist and potential remedies to mitigate these discrepancies.

Statutory Foundations in the Dodd-Frank Act

As previously indicated, section 939A of the Dodd-Frank Act requires that references and reliance on credit rating agencies to be removed from federal regulations. Section 171(b) of the Dodd-Frank Act does not allow the Regulators to promulgate rules that quantitatively lower the RBC requirements of federally insured depository institutions as of July 10, 2010.[28]

Nonetheless, we are concerned that the SSFA has the potential to go beyond the intent of section 939A of the Dodd-Frank Act of not simply replacing credit ratings with an alternative market risk RBC formulation — but also substantially increasing the RBC held by banks.

Regarding references to and reliance on credit ratings in federal regulations, Section 939A requires the following:

> Each such agency shall modify any such regulations identified by the review conducted under subsection (a) to remove any reference to or requirement of reliance on credit ratings and to substitute in such regulations such standard of credit-worthiness as each respective agency shall determine as appropriate for such regulations. In making such

[27] Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements, Federal Reserve p.216 (June 7, 2012).
[28] 76 Fed. Reg. 79398 (December 21, 2011).

> determination, such agencies shall seek to establish, to the extent feasible, uniform standards of credit-worthiness for use by each such agency, taking into account the entities regulated by each such agency and the purposes for which such entities would rely on such standards of credit-worthiness. [29]

The clear focus here is eliminating the reliance on a credit rating-based RBC regime — not a substantial increase in RBC for regulated entities.

As indicated below, the intent of the Proposal is to require similar amounts of risk-based capital as the Basel framework

> Instead of mapping risk-weights to credit ratings, the agencies are proposing alternative standards of creditworthiness to assign risk-weights to certain exposures, including exposures to sovereigns, companies, and securitization exposures, in a manner consistent with section 939A of the Dodd-Frank Act. These alternative creditworthiness standards and risk-based capital requirements have been designed to be consistent with safety and soundness while also exhibiting risk sensitivity to the extent possible. **Furthermore, these capital requirements are intended to be similar to those generated under the Basel framework.**[30] (Emphasis added)

We urge the Regulators to be mindful of the limited scope of the statutory directive as the Regulators continue in this rulemaking and to be responsive to analysis that demonstrates that risk-based capital under the Proposal would be materially greater than the Basel framework.

Simplified Supervisory Formula Approach

This section addresses the SSFA formula, MBA's analysis of the formula, and recommendations for addressing definitional and structural issues with the SSFA.

Revised SSFA Formula

On August 30, 2012, the Regulators promulgated the Final Rule for market risk for trading positions of structured securities.[31] The Final Rule presents a significant refinement of the December 21, 2011 proposed rule for trading accounts[32] and was responsive to some of the concerns that were raised by MBA and other commentators. See Appendix H for MBA's analysis of the December 21, 2011 proposed rule. This revised SSFA formula was included in the Proposal and is shown below:

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[29] Public Law 111-203, 124 Stat. 1887 (July 21, 2010).
[30] Regulatory Capital, Implementation of Basel III: Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions and Prompt Corrective Action, Federal Reserve, p.14, (June 7, 2012).
[31] 77 Fed. Reg. 53060-53115 (August 30, 2011).
[32] 76 Fed. Reg. 79396 (December 21, 2011).

$$K_{SSFA} = \frac{e^{a \cdot u} - e^{a \cdot l}}{a(u - l)}, \text{ where,}$$

$$a = -\frac{1}{p \cdot K_A},$$

$$u = D - K_A,$$

$$l = A - K_A,$$

$$K_A = (1 - W) \cdot K_G + W * 0.5,$$

$$e = 2.71829$$

K_{SSFA} is required regulatory capital,

with the risk-weight equaling K_{SSFA} *12.5

Where:

p = 0.5.
K_G = The RBC for structured securities that is set at 0.08.
A = The attachment point for the position, which represents the threshold in which losses will be first allocated to the position and is expressed as a decimal value between 0 and 1.
D = The detachment point for the position, which represents the threshold in which credit losses of principal allocated to the position would result in the total loss of the position and is expressed as a decimal value between 0 and 1.
W = The ratio of the sum of the dollar amounts of any underlying exposures within the securitized pool that are "delinquent" to the ending balance, measured in dollars, of underlying exposures. "Delinquent" would be defined as the sum of exposures that meet the following requirements:[33]

(i) Ninety days or more past due,
(ii) Subject to a bankruptcy or insolvency proceeding,
(iii) In the process of foreclosure,
(iv) Held as real estate owned,
(v) Has contractually deferred interest payments for 90 days or more, or
(vi) Is in default.

The proposed rule requires that:[34]

If $D<K_A$ then K_{SSFA} is 1250%, if not then K_{SSFA} *1250%
If $A>K_A$ then K_{SSFA}*1250%,

[33] Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements, Federal Reserve p. 221 (June 7, 2012).
[34] Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements, Federal Reserve p.82 (June 7, 2012).

If $A<K_A$ and $D>K_A$ then $[(K_A-A)/(D-A)*1{,}250\%]+[(D-K_A)/D-A)*1{,}250\%*K_{SSFA}]$

Industry Analysis of the Revised SSFA

We would like to share some recommendations that were provided in a June 19, 2012 report by RBS[35] that merits the Regulators' further consideration:

> Foreclosed Loans. The Special Servicers often "dual track" workout negotiations by filing foreclosures contemporaneously to discussions with a borrower. When this occurs, the loan is reported as foreclosed despite it potentially being less than 90-days delinquent. We therefore recommend that loans that are classified as "foreclosed" only because of dual tracking, but are otherwise less than 90-days delinquent be excluded from the SSFA delinquency rate measurement.
>
> Bankrupt Loans. Bankruptcy is not a designated status as reported in the CREFC Investor Reporting Package and instead only flagged in the monthly trustee reports. This potentially results in double counting in vendor provided data of loans that are both 1) bankrupt and 2) ninety days or more past due, in foreclosure or in REO. We therefore recommend that input data be scrutinized to assure such loans are only included once in the SSFA delinquency rate calculation
>
> Defeased Loans. Defeased loans are not specifically addressed in the final SSFA rule. However, the final rule does indicate that cash may be included in the calculation of attachment points. Given this language, we recommend using Defeased Adjusted Credit Enhancement for the SSFA as we believe loans defeased with treasuries have minimal (if any) default risk. Alternatively, we believe the input parameter K_G may be adjusted to reflect the risk mitigation provided by the treasuries securing defeased CMBS loans.
>
> Matured Non-Performing Loans. The reporting of matured non-performing loans is inconsistent across data vendors which creates confusion. For instance, matured non-performing loans are typically not considered as ninety days or more past due in the monthly remittance reports, but are often classified as such by 3rd party data providers (Trepp, Intex and Bloomberg). We recommend regulator clarification, but believe including such loans in the SSFA delinquency rate input is consistent with the spirit of the rule.
>
> Performing Matured Loans. Matured Performing loans are also not specifically addressed in the SSFA. These loans are not considered delinquent by 3rd party data providers or the Master Servicer in the monthly remittance reports despite failing to repay principal at their scheduled maturity date. We again recommend regulator clarification on whether these loans should be considered as part of the calculation of delinquency rate.

Terminology/Definitional Concerns with the SSFA

By introducing a new variable into the formula (W) that accounts for current delinquency in the CMBS, the SSFA formula was modified to take into account the performance of the CMBS. The inclusion of this variable allowed for the problematic look-up table (See Table 7 in Appendix H) to be eliminated. We believe that this represents a significant step forward for improving and refining the SSFA. **However, the SSFA requires further refinement in order for the risk-weights that it generates to be more**

[35] The Devil is in the Details of the SSFA, RBS, p.1 (June 1912, 2012).

consistent with both the existing U.S. ratings-based approach and the EU Basel III framework.

In addition, MBA believes that by including only current delinquency activity in variable W, the Regulators' objective of making the SSFA "forward looking"[36] is much better achieved than through the prior cumulative loss approach. However, since variable W is highly integrated into the SSFA formula and plays a significant role in determining the risk-weight, we closely examined the delinquency measures that comprise variable W. In addition, MBA seeks further clarification on the following issues:

Default Definitional Issues.

A default can be triggered by a variety of causes that may not be linked to the nonpayment of the mortgage such as lapsed insurance coverage, nonpayment of property taxes, etc. The activities that constitute a loan default are specified in the loan documents and may vary from loan to loan. Consequently, this term should be precisely defined in order to avoid inadvertent inclusion of properties that are current in their mortgage payments as being categorized in default for technical compliance issues.

Changes in Security Structure Over Time

As loans pay-off and pay-down, subordination levels and other characteristics of a security change. For example, as a loan pays-off and principal is returned to bond holders, the level of subordination for a particular bond may increase. Likewise, as losses are realized, a bond's subordination level may decrease. Regulators should be clear about the timing and methods for accounting for such changes.

W Variables are Evenly Weighted

Although each of the six delinquency variables has the potential for materially different loss scenarios, they are weighted identically. For example, properties that are in bankruptcy or insolvency proceedings can be potentially tied up for several years in legal proceedings and the lender could ultimately receive lower sale proceeds because the property may have been allowed to languish during the extended litigation period. Whereas, a property that is 90 days past due has the potential for a much shorter resolution timeframe and greater potential for higher sale proceeds than properties in bankruptcy due to better property condition or renegotiated loan terms that are suitable to the lender. As indicated in these two examples, the loss severity can be materially different for the different components of the W variable. Consequently, the Regulators should give strong consideration to weighting the six components of the W variable in a manner that accounts for their respective loss potential and resolution timeframe.

[36] Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements, Federal Reserve p.81 (June 7, 2012).

Components of the W Variable Require Consistency

In order to create consistency in the six components of the W variable, the Regulators should work closely with the data vendors to make sure that required information is both commercially available and is consistent with existing CMBS reporting standards. During this process, we urge the Regulators to be flexible on their data requirements in order to prevent the potential for double counting of data and to create consistency in the components of the W variable among the data vendors.

Structural Concerns and Recommendations for the SSFA

While the above concerns can be readily addressed by more clearly defining the components of the W variable, our larger concern is that certain structural issues with the SSFA were not addressed in the Proposal that create the potential for regulatory arbitrage. These concerns are addressed below:

The Total Level of Credit Support is Not Accounted for by the SSFA Formula

The SSFA formula only accounts for the level of subordination within the structure of the security, not the overall level of subordination. In the case of CMBS, the overall level of credit support is reflected by the average LTV ratio of the mortgages comprising the CMBS plus the subordination within the CMBS structure. The first loss position is the owner's equity, which is reflected in the LTV, and once this is exhausted, additional losses are passed through the CMBS waterfall structure with the tranches with the lowest subordination being last in line for payment. For example, for a CMBS loan that had an LTV of 70 percent, there would be a 30 percent equity cushion that would absorb losses[37] before the CMBS structure is impacted. For a CMBS loan with an 80 percent LTV, this cushion would be 20 percent before losses are passed on to the CMBS structure. This difference in LTV is not accounted for within the SSFA because the proposal only addresses the subordination level within the structure of the security. Consequently, the SSFA does not provide regulatory capital incentive for banks to select "safer" CMBS that have lower LTVs. However, rating agencies take into account the LTV of the underlying assets when assigning ratings to each CMBS tranche.

The Regulators should carefully consider accounting for the total level of credit support within the SSFA. This could be achieved by adding the owners' equity to the CMBS pool amount and starting the attachment point of the first loss position at the last dollar of the owner's equity. This modification to the SSFA formula would allow for the true first loss position, owners equity, to be accounted for in the regulatory capital framework. **By taking the total amount of credit support into account, the SSFA would reduce the potential for regulatory arbitrage between CMBS with different LTVs for their underlying assets.**

[37] If an underlying asset for a CMBS is sold, expenses to the CMBS structure can include: recovery losses if the sale price is below the outstanding mortgage balance, special servicer fees, sales expenses, interest advances, etc.

The SSFA Formula Does Not Account for Differentiation in Structured Security Assets

The SSFA formula applies to all structured securities that as an asset class have a variety of products and structures that can include: CMBS, RMBS, credit cards receivables, automotive loans, etc. The risk-weight generated from the SSFA depends primarily on the subordination level of the structured security position. Categories of structured securities that feature high levels of subordination, are rewarded by a lower risk-weights than categories of structured securities with lower levels of subordination. However, lower subordination levels may not be associated with higher risk levels because certain categories of structured security have lower subordination levels due to the strong performance history of the underlying assets. As a consequence, the required regulatory capital may not reflect the underlying risk of the assets that comprise the structured security. Our concern is that this distortion may cause banks to purchase structured securities based upon their lower regulatory capital charges rather than the quality of the underlying assets. **Consequently, MBA strongly recommends that the Regulators provide an adjustment factor to the SSFA for each category of structured securities that accounts for the different underlying performance of the various structured security categories.**

Gross-Up Approach

This section addresses the definition of the gross-up approach, MBA's structural concerns with the gross-up approach, and a recommendation for addressing these concerns. The Proposal allows banks that are not subject to subpart F of the Proposal to utilize the gross-up approach.

Gross-Up Approach Definition

The gross-up approach is described as follows in the Proposal:

> The gross-up approach assigns risk-based capital requirements based on the full amount of the credit-enhanced assets for which the banking organization directly or indirectly assumes credit risk. To calculate risk-weighted assets under the gross-up approach, a banking organization would determine four inputs: the pro rata share, the exposure amount, the enhanced amount, and the applicable risk-weight. The pro rata share is the par value of the banking organization's exposure as a percentage of the par value of the tranche in which the securitization exposure resides. The enhanced amount is the value of all the tranches that are more senior to the tranche in which the exposure resides. The applicable risk-weight is the weighted-average risk-weight of the underlying exposures in the securitization pool as calculated under subpart D.
>
> Under the gross-up approach, a banking organization would be required to calculate the credit equivalent amount, which equals the sum of the exposure of the banking organization's securitization exposure and the pro rata share multiplied by the enhanced amount. To calculate risk-weighted assets for a securitization exposure under the gross-up approach, a banking organization would be required to assign the applicable risk-

> weight to the gross up credit equivalent amount. As noted above, in all cases, the minimum risk-weight for securitization exposures would be 20 percent.[38]

If a bank chooses to use the gross-up approach, it must use it on all of its securitization exposures, except as exempted under section 44 and 45 of the Proposal.[39] Basically, the gross-up approach assigns the risk-weight based on how far from the top of the capital stack that the structured security position is placed and its percentage of the tranche that it occupies.

Gross-up Approach Analysis and Recommendations

Addressed below are the challenges with the gross-up approach and our recommendations for addressing them:

Gross-up Approach Requires a Minimum 100 Percent Risk-Weight

Because of the mechanics of the gross-up approach, the risk-weight can never be less than 100 percent. Consequently, the gross-up approach is punitive when compared to the SSFA or the ratings-based approaches. Moreover, the gross-up approach does not accurately reflect the underlying risk of security positions with high subordination levels. For example, the last-loss position of a structured security with a subordination level of 95 percent or higher would still be subject to the 100 percent risk-weight, versus 20 percent for the SSFA or ratings-based approach. Although, the gross-up approach is presented as an alternative to the SFFA, a 500 percent higher (100%/20%) risk-weight for structured security positions with high subordination levels compared to the SSFA greatly diminishes the gross-up approach's prospects for adoption. In effect, this approach would not be considered a viable substitute for the SFFA.

Gross-Up Approach Does Not Address the Subordination Level of a Structured Security Position

The gross-up approach assigns a risk-weight based upon how much credit enhancement that the position provides for the tranches above it. However, because of the waterfall payment structure for structured securities, the most at-risk positions are the most junior tranches. As a consequence, the relative risk of a structured security is determined by the level of subordination that the position has relative to the tranches below it, not the credit enhancement that it provides to the tranches above it.

MBA Recommends a "Safe Harbor" within the Gross-Up Approach

In order for the gross-up approach to more accurately reflect the relative risk of the structured security position, the level of subordination below the position should be factored into the risk-weight. This could be accomplished by assigning a subordination

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[38] Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements, Federal Reserve p. 83 (June 7, 2012).
[39] Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements, Federal Reserve p. 83 (June 7, 2012).

factor to the structured security. As a starting point for this process, a "safe harbor" within the gross-up approach should be created for structured securities whose level of subordination makes them highly improbable to experience losses. In the case of CMBS, this safe harbor could focus on CMBS tranches that have a 30 percent minimum subordination level. For these tranches, both the current ratings-based and SSFA approaches assign a 20 percent risk-weight.[40] Consequently, we believe that this is the appropriate risk-weight for CMBS tranches with subordination levels of 30 percent or greater. **By creating a safe harbor within the gross-up approach, community banks, that may have difficulty implementing the SSFA, would have a viable option for holding low-risk structured securities with an appropriate risk-weight**, unlike the minimum 100 percent risk-weight required by the gross-up approach for even a last-loss structured security position.

Analysis of and Recommendations for the Risk-Weight Methodologies

MBA analyzed for the various risk-weight methodologies the tranche by tranche risk-weights of two relatively typical CMBS from two very different market periods, 2012 and 2006.[41] The results of this analysis are shown in Appendix C for UBS-B 2012-C2 and Appendix D for BACM 2006-2. These years were selected for CMBS because they represent a significant range in subordination levels, with subordination levels for the 2012 CMBS issuance being significantly higher than the 2006 CMBS issuance.

The Appendixes show the risk-weights under the following methodologies: U.S. Basel market risk framework ("U.S. Framework"); EU Basel market risk framework[42] ("EU Framework"); 1,250 percent risk-weight approach; SSFA with a minimum 20 percent risk-weight; SSFA without the 20 percent minimum risk-weight; the gross-up approach and the 100 percent risk-weight for commercial mortgages held in portfolio for banks. We developed a scenario in which the Proposal's required 20 percent risk-weight floor was eliminated for the SSFA in order to make useful comparisons with the EU Framework for CMBS tranches with high subordination levels.

While it may not be possible to reconcile the Regulators' objective to "improve the quality and increase the quantity of capital"[43] with their stated objective of "capital requirements are intended to be similar to those generated under the Basel framework"[44], further calibration of the SSFA model will allow the Regulators' other

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[40] The SSFA produces a 20 percent floor risk-weight for tranches with subordination levels of 30 percent or greater for a wide range of default (W variable) scenarios. This analysis was performed using a 2006 and 2012 representative CMBS.

[41] 2012 vintage CMBS, Commercial Mortgage Alert, p. 22 (July 6, 2012); 2006 vintage CMBS, Commercial Mortgage Alert, p.13 (June 16, 2006).

[42] Bank of International Settlements, Basel Committee on Banking Supervision, Revisions to the Basel II Market Risk Framework, p. 7 (February 2011).

[43] Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements, Federal Reserve p.13 (June 7, 2012).

[44] Regulatory Capital Rules: Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective action, p. 14 (June 7, 2012).

objective "to enhance the overall risk-sensitivity of the calculation of a banking organization's total risk-weighted assets"[45] to be achieved. Presented below is our analysis of the SSFA and, where appropriate, we offer recommendations for addressing our concerns with the SSFA:

The SSFA Creates Higher Risk-Weights than the U.S. and EU Ratings-Based Approach

As indicated in the 2006 Vintage CMBS in Appendix D, the EU Framework has significantly lower risk-weights than the U.S. Framework until the B+ rating when both Frameworks require a 1,250 percent risk-weight. In addition, with the exception of tranches with 30 percent and greater subordination, the SSFA produces higher risk-weights than the U.S. Framework. This results in the SSFA producing dramatically higher risk-weights than EU Framework. Consequently, U.S. banks would have to hold significantly more RBC than their European counterparts for such structured securities.

The SSFA Produces a Higher Risk-Weight for Highly Subordinated CMBS Tranches than the EU Framework

For both the 2006 and 2012 CMBS analyzed, the risk-weight for highly subordinated CMBS tranches is identical (20 percent) under the SSFA and the U.S. Framework. However, compared to the EU Framework, the SSFA has a risk-weight that is 286 percent greater for highly subordinated CMBS tranches (7 percent versus 20 percent).

Lower Subordination Levels Create Larger Differences Between the U.S. Framework and the SSFA

When comparing the 2012 and 2006 vintage CMBS, significant risk-weight differences emerge for the CMBS tranches with less than 30 percent subordination levels when comparing the U.S. Framework to the SSFA. For the first tranche after the highly subordinated CMBS tranches, the SSFA risk-weight is 57.6 percent for the 2012 vintage CMBS and the SSFA risk-weight is 72.7 percent for the 2006 vintage CMBS.[46] This difference is due to the lower subordination level of the 2006 tranche, 20.2 percent versus 22.2 percent in 2012.

The SSFA Creates Higher Risk-weights for Non Highly Subordinated CMBS than the U.S. Framework

For both the 2006 and 2012 vintage CMBS, the SSFA results in a higher risk-weight than the U.S. Framework. As the difference in subordination levels for identically rated tranches increases for the two periods, so does the differential in the SSFA. For Example, the 2006 A-J, AAA tranche had a risk-weight of 416.4 percent, while the most

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[45]Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements, Federal Reserve p.13 (June 7, 2012).
[46] These risk-weights for both 2006 vintage and 2012 vintage CMBS were both generated based upon a default (W) variable of 5.0 percent.

junior 2012 AAA tranche had a risk-weight of 57.6 percent.[47] This was due to the lower subordination level of the 2006 AAA tranche, 12.1 percent versus 22.2 percent for the 2012 most junior AAA tranche.

The SSFA is Punitive for Re-securitizations

Because the p variable is increased from 0.5 for securitizations to 1.5 for resecuritizations, the overall risk-weighting for the sample 2012 vintage CMBS would increase from 16.0 percent for the initial securitization to 25.5 percent for a resecuritization, or a 59.3 percent increase. Similar results were found for the 2006 vintage CMBS. Most notable, is the dramatic increase in the risk-weight for highly subordinated tranches. For the 2012 vintage CMBS, the A4/AAA tranche with a 30 percent subordination level will receive an increase in the risk-weight from 20 percent for securitizations to a risk-weight of 119.5 percent for resecuritizations, a six fold increase in the risk-weight, despite this very high subordination level. The last AAA tranche, A-S-EC, with a 22.2 percent subordination level has an increase in risk-weight from 57.6 percent to 438.8 percent. The large difference in the risk-weights between the resecuritized and securitized structured security positions creates a strong deterrent for banks to purchase resecuritizations. Given these dramatically increased risk-weights for CMBS tranches with high levels of subordination, we recommend the Regulators strongly consider recalibrating the p variable in order to more accurately reflect the risks associated with highly subordinated structured security positions. A p variable of 0.6 percent would take into account the reduced transparency of a resecuritization without unduly penalizing the most senior CMBS tranches. Under this scenario, the tranche with the 30 percent subordination level would remain at a 20 percent risk-weight, while the last AAA tranche A-S-EC, would see an increase from a 57.6 percent-risk-weight to a 95.0 percent risk-weight. Subsequent tranches would be assigned progressively higher risk-weights.

SSFA Results in Much Greater Risk-Weight for CMBS than Commercial Real Estate loans

Shown in Table 3, below, is the overall risk-based capital requirement and risk-weight for bank holdings of CMBS and commercial loans under various risk-weight calculation methodologies:

[47] Both scenarios are based upon 5 percent W variable.

Table 3
Risk-Based Capital Methodology for Structured Securities
Risk-Based Capital and Risk-Weights for UBS-B 2012-C2 and BACM 2006-2 Vintage CMBS

	UBS-B 2012-C2		BACM 2006-2	
Risk-Based Capital Methodology	Risk-Based Capital As Percent of CMBS	Risk-Weight	Risk-Based Capital As Percent of CMBS	Risk-Weight
U.S. Basel Market Risk Framework	10.1%	126.2%	4.8%	59.5%
EU Basel Market Risk Framework	7.0%	87.5%	3.2%	39.6%
1250% Risk Weight Approach	100.0%	1250.0%	100.0%	1250.0%
SSFA	16.3%	203.7%	16.0%	200.2%
Gross-Up Approach	38.7%	484.0%	36.4%	455.1%
Commercial Real Estate Loans	8.0%	100.0%	8.0%	100.0%

Table 3 shows the results for two relatively typical CMBS from two very different market periods, 2012 and 2006.[48] For both the 2012 and the 2006 CMBS vintages, **the proposed SSFA risk-weight for CMBS would be more than 100 percent greater than it would be had a bank held the underlying commercial real estate loans in its lending portfolio.** This large differential could potentially lead to distortions in the allocation of capital for regulatory compliance purposes. In order to address this concern, MBA recommends that the Regulators strongly consider recalibrating the SSFA to bring the respective risk-weights for CMBS and commercial loans into closer alignment.

Table 3 illustrates that because of varying subordination levels for different CMBS vintages (2012 and 2006 in this case), the U.S. and EU Frameworks can result in significant fluctuations in risk-weights. In the 2012 example, the market environment and resulting subordination levels for CMBS resulted in a slightly higher risk- weight for CMBS, 126 percent versus 100 percent for commercial real estate loans. With a risk-weight of 87.5 percent for the 2012 vintage CMBS, the less conservative EU Framework still approached the 100 percent risk-weight for commercial mortgages. In order to avoid these year-to-year fluctuations in the overall risk-weight for CMBS, MBA recommends that the SSFA be calibrated to reflect an overall risk-weight set at a fixed target that is no more than the 100 percent risk-weight for commercial mortgages (8 percent of outstanding loan balance) that also takes into consideration the targeted long-term EU Framework risk-weight.

Higher U.S. Risk-Weights May Influence Bank Competitive Landscape

MBA believes that the higher risk-weight charges for U.S. bank holdings for structured securities required by the SSFA may influence the competitive landscape between U.S. and EU banks.

[48] 2012 vintage CMBS, Commercial Mortgage Alert, p. 22 (July 6, 2012); 2006 vintage CMBS, Commercial Mortgage Alert, p.13 (June 16, 2006).

Applying the 7 Percent Risk-Weight Floor to the SSFA

An area that could benefit by the further refinement of the SSFA model is the treatment of highly subordinated CMBS. As previously indicated, both the SSFA and U.S. Framework currently requires a 20 percent risk-weight for these securities. However, the SSFA generated risk-weight is based upon the requirement of a minimum of a 20 percent risk-weight floor be utilized. However, when the SSFA model is used to calculate this risk-weight without this floor, it is less than 3.2 percent for all CMBS tranches that would be classified as highly subordinated for both the 2012 and 2006 CMBS shown Appendix C and D. In fact, this percentage is well below the EU Framework's 7 percent minimum risk-weight requirement. We believe that the risk sensitivity of the SSFA should operate as effectively for low risk CMBS tranches as it does for higher risk CMBS tranches. Unfortunately, the 20 percent risk-weight floor applied to the SSFA truncates the risk-weight of highly subordinated CMBS at levels well above what is generated by both the unrestricted SSFA model and EU Framework.

Given the low risk profile of highly subordinated CMBS, MBA strongly urges the Regulators to set the floor for the SSFA at 7 percent so it will more accurately reflect the risk profile of these securities and provide some limited convergence between the SSFA and EU Framework and is consistent with enhancing the risk sensitivity of the SSFA. Additionally, we believe that this recommendation is fully supported by the Regulators' stated objective for the SSFA:

> The proposed SSFA was designed to apply relatively higher capital requirements to the more risky junior tranches of a securitization that are the first to absorb losses, and relatively lower requirements to the most senior exposures[49]

<u>Treatment of Fannie Mae and Freddie Mac Multifamily Mortgage Backed Securities</u>

For multifamily MBS that are issued and guaranteed by Fannie Mae and Freddie Mac, MBA strongly supports the 20 percent risk-weight. For the tranches of a multifamily MBS that are guaranteed by either Fannie Mae or Freddie Mac, MBA strongly supports the "substitution approach" that allows the 20 percent risk-weight to be applied to the multifamily tranches that Fannie Mae and Freddie Mac guarantee. Tranches of MBS that are not supported by Fannie Mae or Freddie Mac guarantees should receive the same capital treatment as private-label CMBS. For risk-weight and for financial accounting purposes these non-guaranteed tranches should be treated separately from the Fannie Mae and Freddie Mac guaranteed multifamily MBS tranches in order that non-guaranteed tranches not inadvertently trigger enhanced risk-weight for the guaranteed multifamily CMBS tranches. With this clarification, MBA supports the risk-weight treatment of Fannie Mae and Freddie Mac multifamily MBS in the Proposal.

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[49] Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements, Federal Reserve p.80 (June 7, 2012).

Statutory Mortgages for CMBS

In the Commercial Real Estate Mortgage section, MBA recommended that the Regulators apply the statutory mortgage concept to all commercial mortgages that would reduce the RBC charge from 8 percent to 4 percent, provided that certain underwriting conditions are met. For consistency, we also recommend that the statutory mortgage risk-based capital treatment be applied to CMBS. In the case of CMBS, the risk-based capital charge would be based upon the weighted average of statutory and non statutory mortgages. For example, if 50 percent of a CMBS was comprised of statutory mortgages (4 percent base capital requirement) and 50 percent of it was comprised of non-statutory mortgages (8 percent base capital requirement), the weighted average base capital requirement would be would be 6 percent. This would represent the base capital requirement that would be used as an input into the SSFA formula.

Structured Security Due Diligence Requirements

The Proposal indicates if a bank "is unable to demonstrate to the satisfaction of the [AGENCY] a comprehensive understanding of the features of a securitization exposure that would materially affect the performance of the exposure, the [BANK] must assign the securitization exposure a risk-weight of 1,250 percent."[50] The Proposal provides a comprehensive description of the processes that are required to be performed in the structured security purchase due diligence process.[51]

Structured Security Due Diligence Requirements Analysis

Presented below are MBA's concerns regarding the Proposal's due diligence requirements for structured securities:

Uncertainty About Structured Security's Risk-Weight is Created

Although the SSFA may generate a risk-weight of 20 percent for the structured security, failure to demonstrate a comprehensive understanding of the structured security would result in a 1,250 percent risk-weight. We are concerned that, at the regulator's discretion, the RBC for a structured security could potentially be increased from 1.6 percent (20 percent risk-weight) to 100 percent (1,250 risk-weight). The potential for and uncertainty about this increase would give banks great pause in deciding to purchase structured securities, especially small to medium banks that may have concerns about meeting every element of the due diligence requirements in the Proposal. This could influence these banks to purchase higher risk assets that are not subject to the structured securities due diligence requirements.

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[50] Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements, Federal Reserve p.216 (June 7, 2012).
[51] Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements, Federal Reserve p.216 (June 7, 2012).

Structured Security Due Diligence Requirements Would Benefit from Additional Refinement

Similar to the recommendation made regarding the W variable, MBA strongly recommends that additional refinement and clarification be made to the structured security due diligence requirements prior to the issuance of the Final Rule. For the due diligence requirements specified in the Proposal, we believe that Regulators should take into consideration a bank's size and the subordination level of the structured securities that the bank typically purchases. We believe that the Regulators would benefit from meetings and or roundtable discussions with banks of all sizes to refine the appropriate level of bank due diligence for structured security purchases.

Because increasing the capital charge on a structured security to 100 percent could have considerable negative ramifications for a bank, we believe that such an action should only be taken as a final step in a deliberative and iterative review process.

Regulators Should Delay Implementing the Proposal Until Problematic Elements Have Been Addressed

Although the structured security requirements addressed in this section are not scheduled to be implemented until January 1, 2015, MBA believes the Regulators should take the necessary time to carefully consider the portions of Proposal that require additional refinement. Regarding the Proposal's treatment of structured securities, we raised the following concerns:

1. The need to carefully define the six components of the W variable.
2. Structural changes to the SSFA to better reflect the total subordination level of a CMBS.
3. The SSFA needs to be more flexible to address the different subordination levels associated with the different categories of structured securities.
4. The gross-up approach needs to be modified to better reflect the risk profile of structured securities with high levels of subordination.
5. The SSFA risk-weight should not be greater than commercial real estate loans held by banks and should take into consideration the aggregate risk-weight of the EU framework.
6. The Regulators should have the SSFA better reflect the risk profile of structured securities with high subordination levels by applying a 7 percent risk-weight floor.
7. The SSFA formula is highly punitive towards resecuritizations.
8. The due diligence process for structured security purchases needs to have greater flexibility to address the various banking business models, size, and structured security purchase preferences.

We would urge the Regulators to follow a recent example set by the Securities and Exchange Commission which allowed ratings to remain in use for defining a mortgage related security for the following reason:

> **the Commission does not believe that, in the absence of established standards of creditworthiness by the Commission, Congress intended for the statutory definitions to become unworkable or to create market uncertainty regarding the status or meaning of these definitions.** Consequently, the Commission is issuing this transitional interpretation to ensure that the markets can continue to function while the Commission continues its work on rule proposals to establish standards of creditworthiness to implement section 939(e) of the Dodd-Frank Act.[52] (emphasis added)

MBA strongly recommends that the U.S. Basel Framework to remain in place for determining the risk-weights for structured securities while the Regulators address the issues raised in this and other comment letters, even if this process should extend beyond January 1, 2015 implementation date for the SSFA.

Commercial and Multifamily Advances

The Servicer Cash Advances section of the Proposal addresses the treatment of servicing advance facilities provided by banking organizations to advance funds for liquidity purposes.[53] The section specifically defines these facilities as securitization exposures but limits risk based capital holding in the event that the undrawn portion of the facility is an eligible cash advance facility. MBA questions if this provision was meant to cover the types of advances made in US commercial/multifamily lending.

Background

Liquidity advance obligations are long standing provisions of CMBS agreements. These liquidity advances are not extensions of credit nor are they provided pursuant to a credit or liquidity facility. Advances in CMBS simply provide an uninterrupted flow of payment to investors during periods of default. In CMBS transactions, the recovery of advanced funds is senior to:

- payments of interest to bondholders;
- payment of principal to bondholders;
- payment of yield maintenance or other prepayment premiums;
- payment of late payment charges and default interest; and
- payment of other fees or amounts due.

Under the terms of a typical CMBS agreement, the master servicer has an obligation to provide liquidity advances for delinquent principal and interest payments and certain property protection expenses (e.g. delinquent insurance premiums, real estate tax payments) at a loan level. The master servicer's agreement to accept this obligation is

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[52] 77 Fed. Reg. 42981 (July 23, 2012).
[53] Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements, Federal Reserve p.79 (June 7, 2012).

predicated on the design of the security that provides the highest level of protection to recovery of these liquidity advances. The key features of this obligation are:

- The servicer obligation to make each advance is made at a loan level;
- The obligation is subject to the servicer's determination that the advance will be recoverable from payments on the loan or proceeds from the liquidation of the related collateral property;
- The obligation to provide liquidity advances will cease at any time that the servicer determines that the advance will not be recoverable from payments on the loan or proceeds from the liquidation of the related collateral property; and,
- The servicer has a right to recover outstanding liquidity advances from other trust cash flows in the event that any outstanding servicer advances are determined to be non-recoverable from payment on the loan or liquidation of the related collateral property.

Servicers review new advances and outstanding advances regularly to ensure that new advances would be recoverable and that outstanding advances remain recoverable. Appraisals, opinions of value, special servicing reports and other market information are utilized in making these assessments. At any time that a servicer makes a determination that advances made will not be recoverable from the related collateral, it has a right to recover the non-recoverable amounts from cash flows received from other loans in the securitization pool.

No Credit Extension or Facility

The servicer's obligations to make liquidity advances in a CMBS security are not extensions of credit nor are they made pursuant to either a credit or liquidity facility. The advance is not intended to provide credit enhancement, to provide a loan to a borrower nor to fund short term liquidity needs. Rather the advance is meant simply to provide an uninterrupted flow of payments to the CMBS investor. In return, the investor agrees (via the terms of the servicing agreement) to accept the servicer's assessment of recoverability, to allow for recovery of non-recoverable outstanding advances from the cash flow on other collateral properties included in the securitization and to the servicer's right to priority in recovery of advances. As noted above, servicer advances have been a key feature in CMBS securitizations since inception – we are unaware of any loss incurred by a CMBS servicer associated with its advancing requirements.

Since there is no facility related to CMBS liquidity advances, provisions in the Proposal related to the "undrawn portion" of the facility have no context in CMBS advancing.

Recommendations

Advance obligations in CMBS transactions do not provide credit support to the investor, loans to the borrower or fund liquidity needs of either. Each advance is made subject to the servicer's determination of recoverability and, upon determination that advances outstanding will not be recoverable from the related collateral property, the servicer may

immediately begin recovery of these non-recoverable amounts, from cash flow related to other loans in the securitization pool. The structure of CMBS transactions is designed to prevent losses related to advancing obligations. MBA is unaware of any loss incurred by a servicer in relation to its advancing obligations since the inception of CMBS. We therefore recommend that these liquidity advances be excluded from the risk-weighting requirements included in the Proposal.

In the event that these advances are not excluded from these risk-weighting requirements, we request the following changes:

1. Eliminate references to 'facilities' when addressing these advances and refer instead to the servicer's liquidity advance obligation. This change in terminology will allow for a distinction between these advances and the loans or other credit support traditionally provided by credit/liquidity facilities.
2. Specifically exclude CMBS advances similar to those described when referencing risk-weighting related to an undrawn portion of a facility.
3. Modify the eligible cash advance facility as follows with respect to CMBS advances:
    a. Eligible Servicer Cash Advances
    (1) the servicer is entitled to full reimbursement of advances[54], except that a servicer may be obligated to make non-reimbursable advances for a particular underlying exposure if any such advance is contractually limited to an insignificant amount of the outstanding principal balance of that exposure;
    (2) except for advances made by other servicers[55], the servicer's right to reimbursement is senior in right of payment to all other claims on the cash

[54] CMBS servicers are entitled to full recovery of the advance amount upon:
1. Payment of the delinquent amounts by the borrower. The servicer is contractually able to withhold borrower funds to repay the outstanding advances prior to distributing funds to the trust/bondholders (including the AAA bondholders);
2. Resolution of the asset. Outstanding advances are withheld from payoff sale proceeds prior to distribution of the remaining funds to the trust/bondholders (including the AAA bondholders); or,
3. Determination that future or outstanding advances are non-recoverable. The servicer has two avenues for recovery of funds advanced. The first recovery is from funds received from the defaulted borrower or the defaulted asset. The second avenue for recovery is from funds generated by the other assets in the trust. In addition, determinations of non-recoverability are made by the advancing servicer. A non-recoverability determination may impact, based on the advancing servicer's determination, future advances or both future and all or part of the outstanding advances. To the extent that the advance determination affects outstanding advances the servicer is entitled to repay the non-recoverable outstanding advances with funds received from other loans in the trust.

[55] In typical CMBS transactions the requirement for making advances is a master servicer responsibility. Transactions may however allow the Special Servicer to make "emergency" advances where the advance is time critical. CMBS transactions also require that the trustee act as a backup advancer in the event that the master servicer fails to make a required advance. .Additionally where large loans are split among securities, the P&I advancing responsibility is also split. In these cases the aggregate of the outstanding advances has priority for recovery vis a vis the bondholders as described, though one of the advancing parties may have priority over another or the recovery may be on a pari passu basis between the advancing parties.

flows from the underlying exposures of the securitization, though the servicer may agree to exercise this right over time provided that recoverability is not negatively impacted[56]; and
(3) the servicer has no legal obligation to, and does not make, advances to the securitization if the servicer concludes the advances are unlikely to be repaid.

4. Provide that funded CMBS advances that meet the modified eligibility requirements are exempt from risk-weighting requirements.

The Risk-Weighting of FAS 167 Assets

On June 12, 2009, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 166, *Accounting for Transfers of Financial Assets, an Amendment of FASB Statement No. 140* (FAS 166) (now known as Transfers and Servicing (Topic 860), Accounting for Transfers of Financial Instruments under the *FASB Accounting Standards of Codification,* No. 2009-16 dated December, 2009) and Statement of Financial Accounting Standards No. 167, *Amendments to FASB Interpretation No. 46(R)* (FAS 167) (now known as Consolidations (Topic 810), Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities under the *FASB Accounting Standards of Codification,* No. 2009-17 dated December, 2009). ASU 860 and ASU 810 removed the concept of a qualifying special-purpose entity (QSPE) from generally accepted accounting principles (GAAP) and altered the criteria under which special purpose entities, like mortgage-backed securities trusts (MBS), must be included in the issuer's or servicer's consolidated financial statements. The net impact to the mortgage banking and commercial mortgage securities industries was for hundreds of billions of dollars of securitized assets and liabilities to come onto the balance sheets of issuers, servicers or special servicers. Over one trillion of assets and liabilities came back on the balance sheets of Fannie Mae and Freddie Mac.

Bank regulators subsequently enacted a rule that would require banks to maintain regulatory capital on such assets and to include the securitization's assets in the regulatory leverage ratio (FAS 167 Regulatory Capital Rule).

Under the Proposal, the Regulators included the FAS 167 Regulatory Capital Rule whereby a banking organization that transfers exposures it has originated or purchased

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[56] In certain instances, the servicing contract may provide that the servicer recover the advance funds over a short period of time. Additionally, because CMBS transactions may be subject to advancing by two or more servicers, one advancing servicer may have priority over another or the priority may be pari passu with respect to recovery. In all cases however, the advancing servicer has the right to determine advances non-recoverable and the servicers' rights to repayment of the outstanding advances are prior to the rights of the bondholders and upon determination that outstanding advance amounts are non-recoverable, prior to all other claims.

to a securitization Special Purpose Entity (SPE) or other third party in connection with a traditional securitization may exclude the underlying exposures from the calculation of risk-weighted assets only if each of the following three conditions are met: (1) the exposures are not reported on the banking organizations balance sheet under GAAP; (2) the banking organization has transferred to one or more third parties credit risk associated with the underlying exposures; and (3) any clean-up calls to the securitization are eligible clean-up calls. An originating bank that fails to meet these conditions would be required to hold risk-based capital (RBC) against the transferred exposures as if they had not been securitized and would deduct from common equity Tier 1 capital any non-cash after tax gain-on sale resulting from the transaction.

MBA believes that ballooning RBC and leverage ratios by the entirety of assets of sponsored variable interest entities (VIEs) is an inappropriately blunt instrument that does not take into account the nuances of the underlying exposures. MBA members recognize that in some cases it is entirely appropriate to fully charge RBC and inflate leverage ratios of sponsoring entities where there is evidence that the sponsor is likely to provide credit support to the VIE. However, most MBS VIE's do not carry this kind of credit backstop. For most static pool structures, like residential mortgage backed securities (RMBS) and commercial mortgage backed securities (CMBS), the appropriate regulatory capital treatment would be to require RBC and leverage ratio treatment for only the variable interests retained and not for all of the consolidated VIE assets. To do otherwise would unfairly require a banking organization to maintain capital on its balance sheet for assets it does not own and liabilities it does not owe.

If this section of the Proposal is adopted, regulatory capital will continue to be scarce resulting in an adverse impact on consumers for all securitized loan products, as banks increase prices to ration scarce regulatory capital and to cover the additional accounting and administration costs of carrying artificially inflated assets and liabilities. Additionally, residential loans to moderate-to medium- income households will be adversely impacted unless FHA or other government agencies expand their underwriting criteria to provide mortgages to an underserved market resulting from a sluggish private-label mortgage securitizations market that served individuals not eligible for loans qualifying for securities issued by Ginnie Mae, Fannie Mae, or Freddie Mac.

Inclusion of OCI in Regulatory Capital

The Regulatory Capital proposed rule on page 49 would require banks to include in regulatory capital unrealized gains and losses on available for sale (AFS) securities. Under existing GAAP, unrealized gains and losses on AFS securities are carried in the Other Comprehensive Income (OCI) category in the equity section of the balance sheet, but are specifically excluded from regulatory capital. This proposed change could give rise to significant volatility in regulatory capital since OCI can change dramatically even during the last hour of the last day of a quarter as a result of economic announcements happening near quarter end. Since AFS securities are, by definition, not held for sale it makes sense to continue to exclude unrealized gains and losses in OCI from the definition of regulatory capital.

If the Regulators do not take this out of the Proposal, it will force many banks to maintain a buffer or cushion in capital in order to protect against any quarter end economic or market surprises. They will likely accomplish this by shrinking their balance sheet and leverage. The result will be a reduction in available credit to support the ongoing recovery from the recent economic crisis.

VII. Financing of Non-depository Mortgage Companies

Residential Warehouse Lines of Credit

The Proposal makes a significant change to the definition of financial collateral included in the previously exposed proposed standardized approach rules by excluding conforming residential mortgages. This change would significantly reduce the amount of funding available to non-depository mortgage bankers since the warehouse lines will continue to be considered to be commercial loan exposures. If residential mortgage loans were considered to be financial collateral, the warehouse lender could "look through" to the underlying collateral for the appropriate risk-weighting. The proposed Advanced Approach guidance indicates that this decision was based on the perceived lack of liquidity in the particular market. However, this one-size-fits-all approach is inappropriate in the context of warehouse lines of credit because the mortgages collateralizing them are subject to forward sale contracts. Thus, these mortgages are, for all intents and purposes, very liquid and price certain and expected to be paid off by sale into the secondary market anywhere from 5 days to within 90 days. Historically, the average turn time is 15 days.

Warehouse providers funded $570 billion[57] of mortgage transactions in the U.S. in 2011, through several types of lending structures. To name a few of them, Line of Credit, Repo Agreements, and Master Participation Agreements. These all operate in a similar manner; however, the legal ownership of the mortgage notes does vary between instruments.

Warehouse lending is the function of providing the necessary liquidity to an independent mortgage banking company to fund the closing of mortgages. It is a short-term revolving facility that funds a lender's inventory from the closing table to sale in the secondary market. The mortgage note is used as collateral or the negotiable instrument that supports the interim financing until the mortgage is sold and delivered to the permanent investor, at which the initial advance of the funds from the warehouse provider is repaid. However, in this case the mortgage has been pre-committed for sale to approved investors, FHA/VA, or committed for delivery into Ginnie Mae, Fannie Mae or Freddie Mac MBS. Those commitments are part of the collateral pool for the warehouse line. Mortgage bankers draw upon the line of credit to fund a mortgage at closing or to purchase a closed loan from another originator. The line of credit is then paid down when the loan is sold to the permanent investor.

MBA strongly believes conforming and/or FHA/VA residential mortgages should be included in the definition of financial collateral. Particularly in the context of warehouse lending, conforming and/or FHA/VA residential mortgages are a readily accessible and uniquely liquid asset. The current business model of mortgage banking is dependent on a credit line whose affordability relies on the near-certain liquidity of the pre-sold

[57] The Reynolds Group, *Annual Warehouse Lender Survey,* June 2012, page 16.

underlying mortgages. The proposed risk-based capital treatment of warehouse lines will continue the current requirement to treat such lines as commercial loan exposures with no "look through" to the highly liquid collateral.

MBA also points out that the cumulative impact of all aspects of the proposed rules as relates to the treatment of residential mortgage loans, MSRs and servicing advances will likely drive a significant portion of residential mortgage lending from depository to non-depository institutions. However, the capacity of non-depositories to absorb the increase in volume will be related to the availability of sufficient, affordable warehouse lines of credit. Granting a "look through" to the underlying collateral of residential mortgages securing warehouse lines of credit would likely improve warehouse line of credit availability and pricing, or at a minimum enable the current warehouse capacity to remain in full force.

Repo Financing and Master Participation Agreements

The Proposal applies a 100 percent Credit-Conversion Factor (CCF) to off-balance sheet repurchase agreements, doubling the current rate of 50 percent.[58] The CCF is applied to the market value of the amount lent or borrowed under the transaction. MBA believes this approach ignores the reality of repurchase agreements, or any similar type funding vehicle that enables the warehouse provider to book the underlying mortgages as an asset acquired, and in doing so unnecessarily increases the cost of capital to mortgage lenders and ultimately consumers.

In a repurchase agreement, or repo, one party sells assets or securities to another and agrees to repurchase them later at a set price on a date certain. Terms on a repurchase agreement can be as short as overnight, or as long as a couple months or more. In a repo the repurchase price is slightly higher than the sales price; this is the interest on the loan. When expressed as an annualized percentage of the sale price it is known as the repo rate. A key feature of this transaction is that the buyer/lender does not merely acquire a lien or security interest in the asset in question, but actual title and ownership. This feature is a significant reason why the repo transaction is a popular and affordable means of financing.

An added feature is that a repurchase agreement can qualify as a true sale under FAS 166. In such cases, the passing of title is recognized as an asset transfer on the books of the respective parties. Under this scenario, the only exposure is to the assets underlying the transaction, i.e. the mortgages or MBS.[59] At this point, the distinction between a repurchase agreement and the holding of a portfolio loan disappears, and so too should the disparate treatment.

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[58] See Standardized Approach at p. 39

[59] Because the banking organization owns the asset, the effect of a default by a counter-party is minimized because the banking organization merely keeps the asset. The only remaining liability is under contract law for costs and/or losses incurred in selling the asset elsewhere.

Even if the transaction does not pass the true sale test, the reality of repurchase agreements should obviate the need for the harsh approach contained in the Proposal. At the outset, the lack of true sale classification for accounting purposes does not alter the reality that the lending party in a repurchase agreement takes title to the asset offered as collateral. As such, the practical reality holds that the lender's true exposure is not to its counter-party, but to the value of the underlying assets. The absence of a true sale under GAAP can perhaps justify the 50 percent CCF currently applied in recognition of the variable of counter-party exposure. However, this in no way can support risk-weighing the entirety of the transaction.

The proposal is doubly harmful because residential mortgages are excluded from the definition of financial collateral. Conforming residential mortgages are among the safest and most liquid financial assets available, and serve as valuable collateral in a variety of transactions that are essential to the mortgage finance market. Many carry explicit government guarantees, and there is no plausible argument for not recognizing the benefits to allowing sophisticated parties to use such assets as collateral.[60] At the very least, residential mortgages used in repos should be risk-weighted according to their LTV and Category 1 or 2 classifications and included in the definition of financial collateral.

In the commercial real estate sector, repurchase agreements are a key form of mortgage finance, particularly for Real Estate Investment Trusts (REITs), entities whose industry has the potential to bring substantial balance sheet capacity to the mortgage finance market. A sizable portion of REIT financing occurs through repurchase agreements. The cost of these agreements will increase significantly under the Proposal, and in the process will stifle the nascent recovery of the private-sector mortgage market. Repurchase agreements are also essential for independent mortgage bankers, who rely on these transactions to finance their loans held for sale during the gestation period between receiving initial pool certification and issuing the MBS.

A shortage of warehouse funds occurred during the 2007- 2009, mortgage meltdown. A number of various size financial institutions increased their opportunities and have absorbed the liquidity shortfall. These institutions provide an immeasurable amount of necessary capital to the mortgage industry. The unfavorable approach the CCF would create would easily undermine a still somewhat fragile real estate environment.

MBA recommends that the Proposal be revised to allow reporting entities the option of looking through the repo structure to the financial collateral held therein, including the inclusion of residential mortgages in the definition of financial collateral.

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[60] These include FHA and VA loans, and Ginnie Mae MBS

VIII. Off-Balance Sheet Exposures

Credit-Enhancing Representations and Warranties

The Proposal requires the application of a 100 percent CCF to credit-enhancing representations and warranties (reps & warranties). These include early payment default clauses, while excluding, among others, warranties that permit the return of assets in instances of fraud, misrepresentation, or incomplete documentation.[61] MBA interprets this exclusion as referring to the ordinary seller reps & warranties common in current sale agreements, and we request confirmation or clarification on this point.

The Proposal is overly harsh because it applies a broad, one-size-fits-all approach to an off-balance sheet exposure that is already covered by reserves on the balance sheet. FASB Interpretation 45 (FIN 45) already requires recognition for the types of reps & warranties covered by the Proposal.[62]

Additionally, the Proposal appears to do away with a valuable exclusion that aids regulatory and capital efficiency. Provisions such as early default protection usually expire within 120 days and are currently not subject to RBC requirements under the "safe harbor." However, this safe harbor does not appear in the Proposal. Requiring banking organizations to hold capital against these temporary exposures will keep much needed capital idle while contributing minimally, if at all, to safety and soundness.

As an alternative to the Proposal's model-driven approach, **MBA recommends continuing the existing 120 days "safe harbor" for credit enhancing reps and warranties, and removing the application of the CCF.** Regulators can then perform periodic examinations of the adequacy of the FIN 45 reserves and reserve process as part of the regular examination. This approach will provide a more accurate and nuanced picture of the safety and soundness of an institution than using the blunt instrument contained in the proposed Credit Conversion Factor.

Residential Mortgages Sold With Recourse

The Proposal converts to an on-balance sheet credit equivalent residential mortgages that are sold with recourse, and applies to these exposures a 100 percent CCF. As a matter of practice, banking organizations already reserve capital on-balance sheet for both indemnified loans and loans sold with recourse. **MBA believes that the Proposal must allow for capital reserved against the converted exposure to be added into Tier 2 Capital as an Allowance for Loan and Lease Losses, as is currently the case for comparable on-balance sheet exposures and related allowances for credit losses.** Such recognition would more accurately reflect the true capital position of the banking organization and avoid unnecessary penalties based on the form, rather than substance, of a transaction.

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[61] *See* Standardized Approach, pp. 39-40.
[62] FASB Interpretation No. 45, ¶ 3.

Appendix A

What Are the Servicer's Revenues and Expenses?

When examining the economics of servicers, it is first important to understand all revenues and costs associated with servicing operations, some of which are often overlooked.

Revenues

During 2003–2011, servicing revenues averaged 31–43 basis points for large prime servicers and 31–39 basis points for small prime servicers. The components of servicing revenues include servicing and subservicing fees net of guarantee fees, ancillary fees such as late payments, and interest earnings on P&I and T&I accounts held in escrow prior to remittances to investors, insurers and tax authorities (float benefit).

Since 2007, servicing revenues have been declining. Contributing factors to the decline include: longer foreclosure timelines (during which agency servicers do not receive a service fee); declines in total mortgage debt outstanding; uncollectable excess servicing (any amounts of interest received by the servicer in excess of "normal" servicing fee); changes in guarantee fees, and drop in earnings on T & I and P & I related to the historically low rate environment.

Expenses

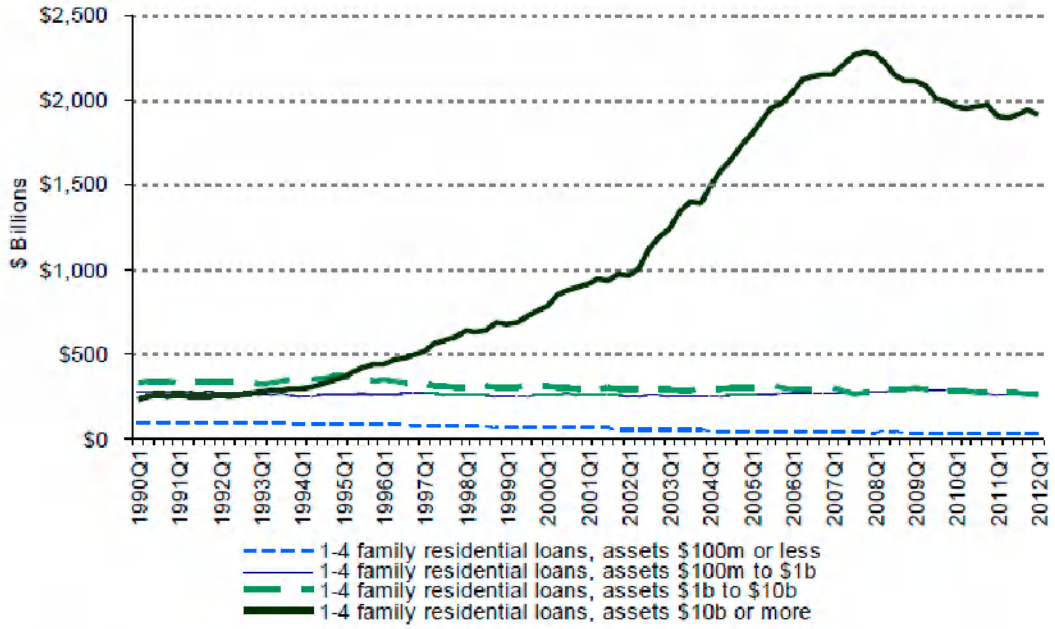
Servicing costs include more than simply the direct cost to service. The key components of the total servicing costs include direct servicing costs, unreimbursed foreclosure and REO-related servicer expenses, corporate allocations, and various types of interest expenses primarily for advances and prepayments. Fully-loaded total servicing costs averaged 12–21 basis points for large prime servicers and 15–21 basis points for small prime servicers during 2003–2011. Since 2007, all components of servicing costs increased, except for interest expenses. While default-related advances increased during this period, many servicers (particularly those bank-affiliated servicers) have been helped by low short-term interest rates that have kept down the cost of funding such advances.

Net Operating Income and Net Financial Income

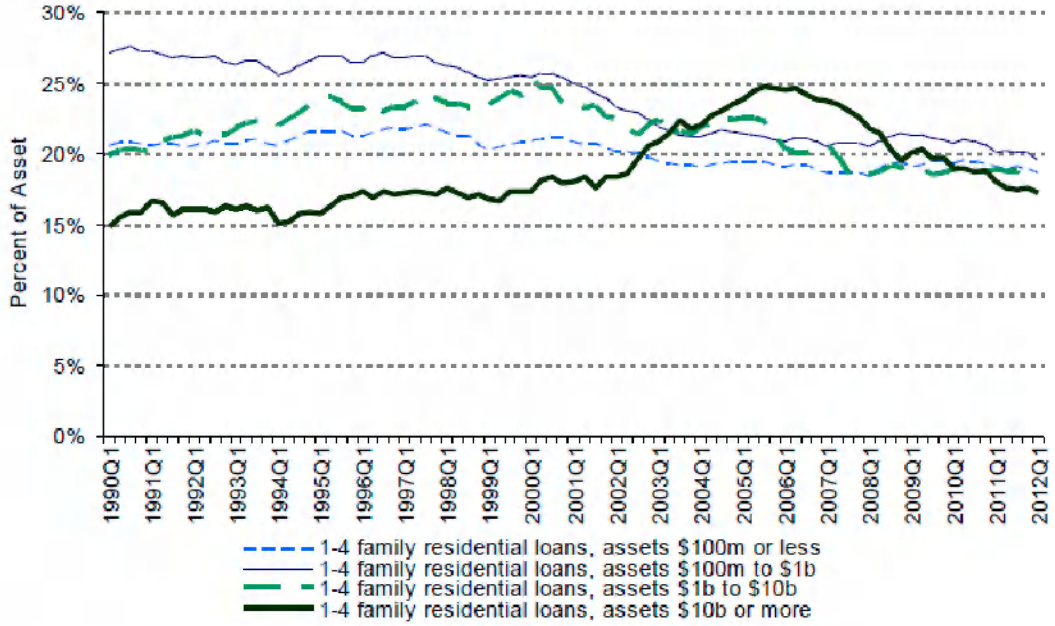
Servicing net operating income is defined as total revenues less total servicing expenses. From 2003 through 2011, large prime servicers' net operating income ranged from 17–30 basis points, while small prime servicers' net operating income ranged from 15–19 basis points. Servicing net financial income, on the other hand, incorporates gains and losses on the valuation of mortgage servicing rights net of hedging. During 2003–2011, net servicing financial income has ranged from a loss of 9 basis points to income of 13 basis points for large prime servicers and a loss of 8 basis points to income of 5 basis points for small prime servicers.

Appendix B

1-4 Family Residential Loans, By Institution Asset Size

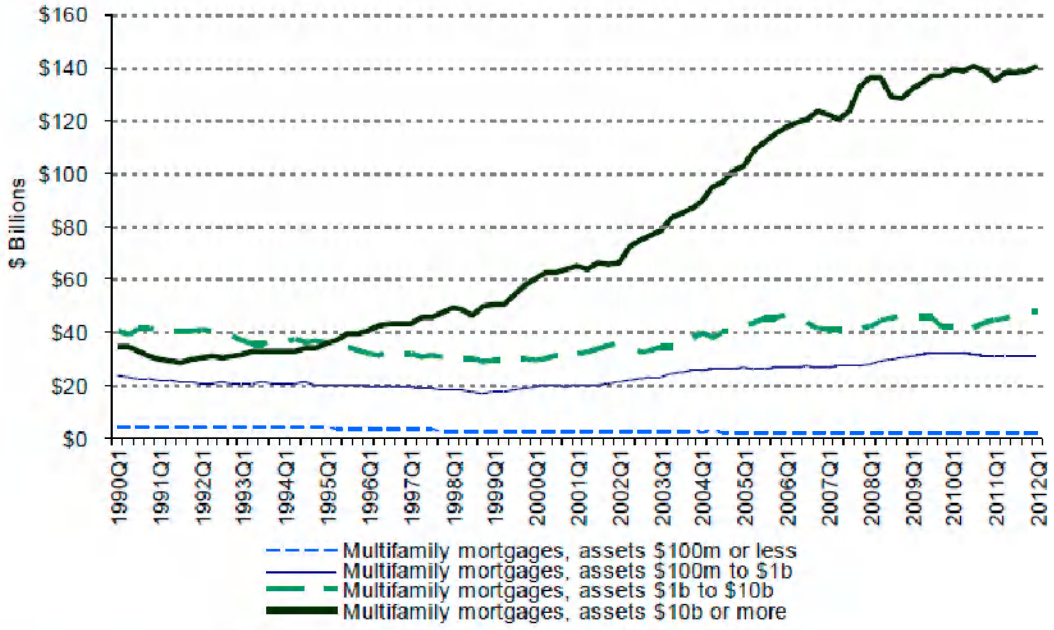


1-4 Family Residential Loans As A Percent of Assets, By Institution Asset Size

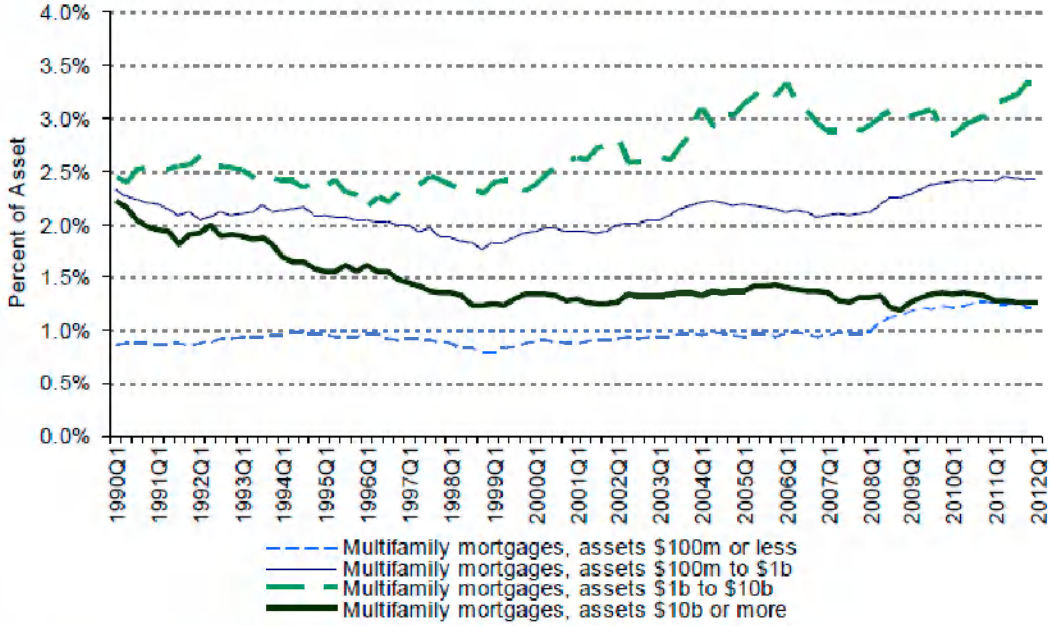


Sources: MBA and FDIC

Multifamily Mortgages, By Institution Asset Size

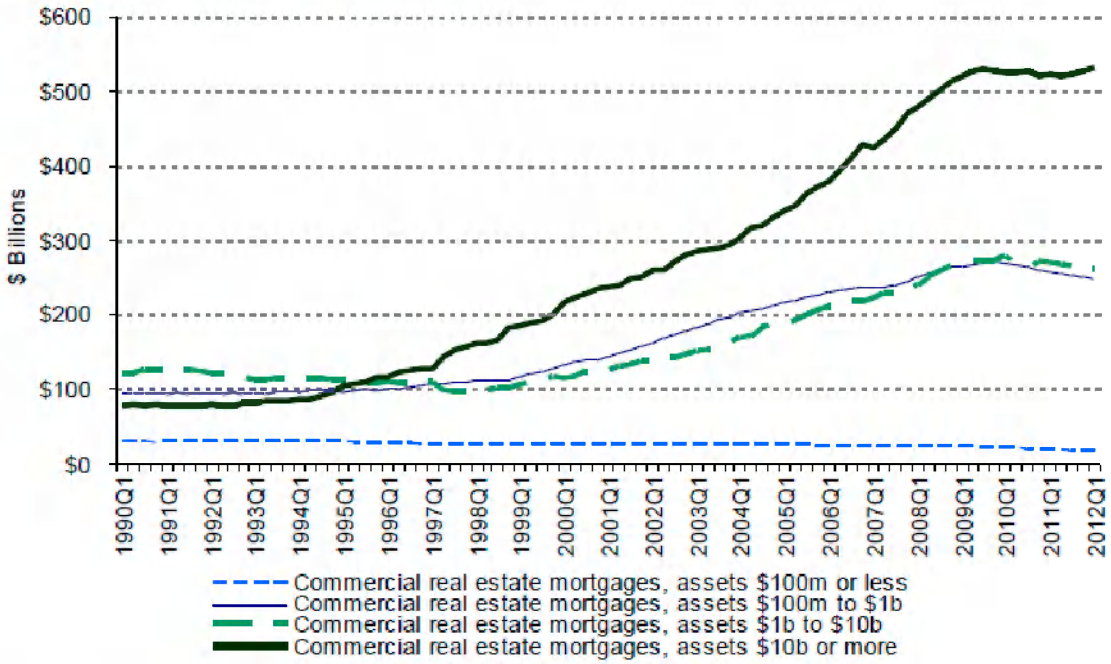


Multifamily Mortgages As A Percent of Assets, By Institution Asset Size

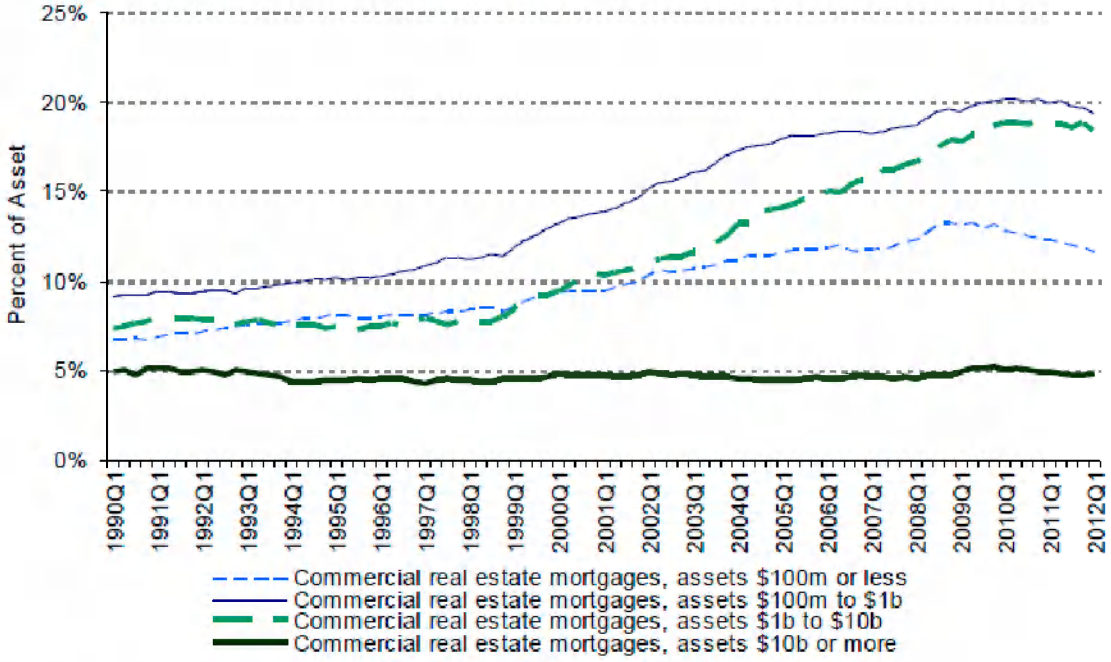


Sources: MBA and FDIC

Commercial Mortgages, By Institution Asset Size



Commercial Mortgages As A Percent of Assets, By Institution Asset Size



Source: MBA and FDIC

Appendix C

Appendix
2012 Vintage CMBS
CMBS Class/Rating - 5% Distressed Loans

	30% or More Subordination														
	A-1 /AAA	A-2/AAA	A-3/AAA	A4/AAA	A-S-EC/AAA	B-EC/AA	C-EC/A	D/BBB+	E/BBB-	F/BB	G/B	H/NR			
Risk Weight by Risk-Based Capital Methodology															
U.S. Basel Market Risk Framework	20.0%	20.0%	20.0%	20.0%	20.0%	20.0%	50.0%	100.0%	350.0%	1250.0%	1250.0%	1250.0%			
EU Basel Market Risk Framework	7.0%	7.0%	7.0%	7.0%	7.0%	8.0%	10.0%	35.0%	100.0%	425.0%	1250.0%	1250.0%			
1250% Risk Weight Approach	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%			
SSFA with 20% Minimum	20.0%	20.0%	20.0%	20.0%	57.6%	198.2%	472.8%	821.9%	1250.0%	1250.0%	1250.0%	1250.0%			
SSFA without 20% Minimum	0.00005%	0.00049%	0.00442%	3.1%	57.6%	198.2%	472.8%	821.9%	1250.0%	1250.0%	1250.0%	1250.0%			
Gross-Up Approach	100.0%	146.0%	319.5%	177.5%	1003.2%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%			
CMBS Risked-Based Capital By Tranche													Total RBC	% of CMBS	Risk-Weight
U.S. Basel Market Risk Framework	1,287	2,797	1,861	7,675	1,508	1,021	1,824	1,946	13,194	22,801	24,321	42,562	122,797	10.1%	126.2%
EU Basel Market Risk Framework	451	979	651	2,686	528	409	365	681	3,770	7,752	24,321	42,562	85,154	7.0%	87.5%
1250% Risk Weight Approach	80,451	174,804	116,311	479,671	94,245	63,842	45,602	24,322	47,122	22,801	24,321	42,562	1,216,054	100.0%	1250.0%
SSFA with 20% Minimum	1,287	2,797	1,861	7,675	4,344	10,124	17,249	15,993	47,122	22,801	24,321	42,562	198,136	16.3%	203.7%
SSFA with 20% Without Minimum	0	0	0	1,193	4,344	10,124	17,249	15,993	47,122	22,801	24,321	42,562	185,710	15.3%	190.9%
Gross-Up Approach	6,436	20,420	29,725	68,099	75,639	63,842	45,602	24,322	47,122	22,801	24,321	42,562	470,891	38.7%	484.0%
Portfolio Lending Requirement 8%	6,436	13,984	9,305	38,374	7,540	5,107	3,648	1,946	3,770	1,824	1,946	3,405	97,284	8.0%	100.0%

Appendix D

Appendix
2006 Vintage CMBS
CMBS Class/Rating - 5% Distressed Property Scenario

	30 Percent and Greater Subordination																					
Risk Weight by Risk-Based Capital Methodology	A 1/AAA	A 1A/AAA	A 2/AAA	A 3/AAA	A AB/AAA	A 4/AAA	A M/AAA	A J/AAA	B/AA	C/AA	D/A	E/A	F/BBB+	G/BBB	H/BBB	J/BB-	K/BB	L/BB	M/B+	N/B	O/B	P/NR
U.S. Basel Market Risk Framework	20.0%	20.0%	20.0%	20.0%	20.0%	20.0%	20.0%	20.0%	20.0%	50.0%	50.0%	100.0%	100.0%	100.0%	350.0%	350.0%	350.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%
EU Basel Market Risk Framework	7.0%	7.0%	7.0%	7.0%	7.0%	7.0%	7.0%	7.0%	8.0%	12.0%	12.0%	20.0%	35.0%	60.0%	100.0%	250.0%	425.0%	650.0%	1250.0%	1250.0%	1250.0%	1250.0%
1250% Risk Weight Approach	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%
SSFA with 20% Minimum	20.0%	20.0%	20.0%	20.0%	20.0%	20.0%	72.7%	416.4%	1013.9%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%
SSFA with 20% Without Minimum	0.0%	0.0%	0.0%	0.0%	0.0%	2.6%	72.7%	416.4%	1013.9%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%
Gross Up Approach	100.0%	156.5%	519.7%	345.9%	523.0%	148.9%	788.9%	1086.1%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%	1250.0%
U.S. Basel Market Risk Framework	1,664	2,943	1,398	2,320	1,597	20,308	4,319	3,455	510	1,080	1,619	2,159	2,429	2,159	9,447	2,834	3,779	10,121	3,374	6,748	6,748	37,112
EU Basel Market Risk Framework	582	1,030	384	812	664	7,108	1,511	1,209	324	259	389	432	850	1,296	2,699	2,024	4,589	5,263	3,374	6,748	6,748	37,112
1250% Risk Weight Approach	104,300	183,944	68,600	145,000	118,565	1,269,250	269,938	215,927	50,638	26,991	40,486	26,991	30,364	26,991	33,739	10,121	13,496	10,121	3,374	6,748	6,748	37,112
SSFA with 20% Minimum	1,664	2,943	1,398	2,320	1,597	20,308	15,732	71,934	41,049	26,991	40,486	26,991	30,364	26,991	33,739	10,121	13,496	10,121	3,374	6,748	6,748	37,112
SSFA with 20% Without Minimum	0	0	0	0	0	2,649	15,732	71,934	41,049	26,991	40,486	26,991	30,364	26,991	33,739	10,121	13,496	10,121	3,374	6,748	6,748	37,112
Gross Up Approach	8,320	23,036	28,524	40,124	49,609	151,149	170,341	187,616	50,638	26,991	40,486	26,991	30,364	26,991	33,739	10,121	13,496	10,121	3,374	6,748	6,748	37,112
Portfolio Lending Requirement 5%	8,320	14,716	5,488	11,600	9,455	101,540	21,593	17,274	4,049	2,159	3,239	2,159	2,429	2,159	2,699	810	1,080	510	270	540	540	2,969

Appendix E

Impact of Changing Risk Weights

Current capital requirements

Mortgage (80 LTV, category 1 loan)	$100	
Funded with:		At cost of:
Deposits	$96	2%
Capital (50% risk weight, 4% capital)	$4	15%
Total cost of funding		2.52%

Proposed Basel III risk weights

Mortgage (80 LTV, category 1 loan)	$100	
Funded with:		At cost of:
Deposits	$96	2%
Capital (50% risk weight, 4% capital)	$4	15%
Total cost of funding		2.52%

Proposed Basel III risk weights and capital conservation buffer

Mortgage (80 LTV, category 1 loan)	$100	
Funded with:		At cost of:
Deposits	$94.75	2%
Capital (50% risk weight, 5.25% capital)	$5.25	15%
Total cost of funding		2.68%

Impact on consumer mortgage rate	**0.16%**
(assuming cost increase in passed through in competitive market)	

Impact of Changing Risk Weights

Current capital requirements

Mortgage (80 LTV, category 2 loan)	$100	
Funded with:		At cost of:
Deposits	$96	2%
Capital (50% risk weight, 4% capital)	$4	15%
Total cost of funding		2.52%

Proposed Basel III risk weights

Mortgage (80 LTV, category 2 loan)	$100	
Funded with:		At cost of:
Deposits	$92	2%
Capital (100% risk weight, 8% capital)	$8	15%
Total cost of funding		3.04%

Proposed Basel III risk weights and capital conservation buffer

Mortgage (80 LTV, category 2 loan)	$100	
Funded with:		At cost of:
Deposits	$89.50	2%
Capital (100% risk weight, 10.5% capital)	$10.50	15%
Total cost of funding		3.37%

Impact on consumer mortgage rate (assuming cost increase in passed through in competitive market)	**0.85%**

Impact of Changing Risk Weights

Current capital requirements

Mortgage (95 LTV with MI, category 1 loan)	$100	
Funded with:		At cost of:
Deposits	$96	2%
Capital (50% risk weight, 4% capital)	$4	15%
Total cost of funding		2.52%

Proposed Basel III risk weights

Mortgage (95 LTV with MI, category 1 loan)	$100	
Funded with:		At cost of:
Deposits	$92	2%
Capital (100% risk weight, 8% capital)	$8	15%
Total cost of funding		3.04%

Proposed Basel III risk weights and capital conservation buffer

Mortgage (80 LTV, category 2 loan)	$100	
Funded with:		At cost of:
Deposits	$89.50	2%
Capital (100% risk weight, 10.5% capital)	$10.50	15%
Total cost of funding		3.37%

Impact on consumer mortgage rate	**0.85%**
(assuming cost increase in passed through in competitive market)	

Impact of Changing Risk Weights

Impact of Changing Risk-weights

Current capital requirements

Mortgage (95 LTV with MI, category 2 loan)	$100	
Funded with:		At cost of:
Deposits	$96	2%
Capital (50% risk-weight, 4% capital)	$4	15%
Total cost of funding		2.52%

Proposed Basel III risk-weights

Mortgage (95 LTV with MI, category 1 loan)	$100	
Funded with:		At cost of:
Deposits	$84	2%
Capital (200% risk-weight, 16% capital)	$16	15%
Total cost of funding		4.08%

Proposed Basel III risk-weights and capital conservation buffer

Mortgage (80 LTV, category 2 loan)	$100	
Funded with:		At cost of:
Deposits	$79.00	2%
Capital (200% risk-weight, 21% capital)	$21.00	15%
Total cost of funding		4.73%

Impact on consumer mortgage rate	**2.21%**
(assuming cost increase in passed through in competitive market)	

Appendix F

Appendix F **50 Percent Risk-Weight Qualification Requirements for Multifamily Loans** **Existing Law and Basel III**		
Requirement	**Current Bank Regulatory Capital Requirements**[63]	**Basel III Proposed Rule**[64]
Multifamily Loan	A loan secured by a first lien on multifamily residential properties consisting of 5 or more dwelling units. It also includes a multifamily mortgage loan that on March 18, 1994 was a first mortgage loan on an existing property consisting of 5-36 dwelling units with an initial loan-to-value ratio of not more than 80% where an average annual occupancy rate of 80% or more of total units had existed for at least one year, and continues to meet these criteria.	The NPR would define statutory multifamily mortgage as a loan secured by a multifamily residential property that meets the requirements under section 618(b)(1) of the RTCRRI Act.
Amortization Period	The amortization of principal and interest occurs over a period of not more than 30 years.	Amortization of principal and interest on the loan must occur over a period of not more than 30 years and
Minimum Maturity Period	The original minimum maturity for repayment of principal on the loan is not less than seven years.	The minimum original maturity for repayment of principal must not be less than 7 years.
Timely Payment	When considering the loan for placement in a lower risk-weight category, all principal and interest payments have been made on a timely basis in accordance with its terms for the preceding year.	All principal and interest payments on the loan must have been made on time for at least one year prior to applying a 50 percent risk-weight to the loan, or in the case where an existing owner is refinancing a loan on the property, all principal and interest payments on the loan being refinanced must have been made on time for at least one year prior to applying a 50 percent risk-weight to the loan.
Performing Loan	The loan is performing and not 90 days or more past due.	The loan is not more than 90 days past due, or on nonaccrual.
Underwriting Standards	The loan is made by the savings association in accordance with prudent underwriting standards.	The loan is made in accordance with prudent underwriting standards.
Fixed Interest Rate	The interest rate on the loan does not change over the term of the loan.	The interest rate on the loan does not change over the term of the loan.
Loan to Value (Fixed Interest Rate)	The current loan balance amount does not exceed 80 percent of the value of the property securing the loan.	The LTV ratio of the loan, calculated in accordance with section 32(g)(3) of the proposal, does not exceed 80 percent.

[63] P.L. 102-233
[64] Title 12 - Banks and Banking. CHAPTER V - OFFICE OF THRIFT SUPERVISION, DEPARTMENT OF THE TREASURY. PART 567 - CAPITAL. Subpart B - Regulatory Capital Requirements, Section 567.1 Definitions.

Appendix F
50 Percent Risk-Weight Qualification Requirements for Multifamily Loans
Existing Law and Basel III

Requirement	Current Bank Regulatory Capital Requirements[63]	Basel III Proposed Rule[64]
Debt Service Coverage (Fixed Interest Rate)	For the property's most recent fiscal year, the ratio of annual net operating income generated by the property (before payment of any debt service on the loan) to annual debt service on the loan is not less than 120 percent, or in the case of cooperative or other not-for-profit housing projects, the property generates sufficient cash flows to provide comparable protection to the institution.	Annual net operating income (before debt service on the loan) generated by the property securing the loan during its most recent fiscal year must not be less than 120 percent of the loan's current annual debt service or, in the case of a cooperative or other not-for-profit housing project, the property must generate sufficient cash flow to provide comparable protection to the banking organization.
Variable Interest Rate	The interest rate on the loan can change over the term of the loan.	The interest rate on the loan can change over the term of the loan.
Loan to Value (Variable Interest Rate)	The current loan balance amount does not exceed 75 percent of the value of the property securing the loan.	The LTV ratio of the loan, calculated in accordance with section 32(g)(3) of the proposal, does not exceed 75 percent.
Debt Service Coverage (Variable Interest Rate)	For the property's most recent fiscal year, the ratio of annual net operating income generated by the property (before payment of any debt service on the loan) to annual debt service on the loan is not less than 115 percent, or in the case of cooperative or other not-for-profit housing projects, the property generates sufficient cash flows to provide comparable protection to the institution.	Annual net operating income (before debt service on the loan) generated by the property securing the loan during its most recent fiscal year must not be less than 115 percent of the loan's current annual debt service or, in the case of a cooperative or other not-for-profit housing project, the property must generate sufficient cash flow to provide comparable protection to the banking organization.

Appendix G

MBA's Risk-Based Capital Principles

Given the fragile state of the economy and current real estate market conditions, MBA strongly supports regulatory regimes that promote the return of private capital to the real estate market. re-establishment of a fully-functioning, liquid and responsible capital market should be a primary policy objective. This is necessary for the nation's residential and commercial real estate sectors to flourish.

Because this Proposal has the potential to impact bank capital allocation decisions, we urge the Regulators to carefully consider all the intended and potentially unintended consequences. In order to assist in this process, MBA developed a set of considerations that we would encourage the Regulators to employ in their evaluation of the Proposal:

- **Attracting Private Capital to the Real Estate Markets** - Private capital is essential to well-functioning residential and commercial real estate markets. The risked-based capital regime should not negatively influence the return of private capital to these markets.
- **Promote the Efficient Allocation of Capital Within Banks** –The allocation of capital to the various asset classes should take into account the relative economic risks and rewards of each of the investment opportunities. The risk-based capital regime should not unduly influence the efficient allocation of bank capital purely for regulatory compliance purposes.
- **Reduce Regulatory Arbitrage** – MBA believes that risk-based capital regulations should be developed in a manner that reduces the opportunity for regulatory arbitrage. Bank entities, as determined by the scope of their operations, domestic or worldwide, should not fall under risk-based capital regulatory regimes that require banks to hold materially different risk-based capital. This would provide banks with a reduced risk-based capital requirement with a competitive advantage and potentially lead to regulatory arbitrage.
- **Efficient Implementation** - The risk-based capital regime should be structured so it can be implemented by banks of all sizes in a cost efficient and timely manner that does not place a strain on their resources. In terms of the data required to comply with the risk-based capital regime methodology, banks of all sizes and their compliance resources should be considered.
- **Intent of the Dodd-Frank Act** – The intent of the Dodd-Frank Act was to eliminate the overreliance on credit ratings by removing them from federal regulations, not precipitously increase risk-based capital for U.S. Banks. The risk-based capital regime should not have a material impact on the market risk risk-based capital for all banks.

Appendix H

SSFA Proposal for Trading Positions

Introduction

On December 21, 2011 the Regulators issued for comment a proposed rule for market risk RBC for trading positions that introduced the SSFA.[1] The SSFA was proposed as a simplified version of the Basel II advanced supervisory formula approach to assign specific risk-weighting factors to securitization positions, including resecuritization positions. The SSFA is designed to apply relatively higher capital requirements to the more risky junior tranches of a securitization that are the first to absorb losses and relatively lower requirements to the most senior positions.[1]

On June 7, 2012, the Regulators jointly promulgated the Final Rule for the market risk RBC SSFA for trading positions. The Proposal applies the trading position SSFA to all bank holdings of structured securities. The SSFA formula was significantly modified in the June 7, 2012 Final Rule. These modifications represent a positive step forward in terms of recognizing underlying risk elements of structured securities. However, as will be discussed in the next section, some implementation and structural issues with the SSFA remain. The June 7, 2012 trading position final rule is very significant because it was lifted and placed in the Proposal for not just trading positions accounts but for all bank holdings of structured securities.

Discussed below are the SSFA formulas from the December 21, 2011 proposed rule and the June 7, 2012 Final Rule.

December 21, 2011 SSFA Proposed Rule

Shown below is the December 21, 2011 proposed SSFA rule:

$$a = -\frac{1}{p \cdot K_G}$$

$$u = D - K_G$$

$$l = A - K_G$$

$e = 2.71828$, the base of the natural logarithms.

(2) Then:

$$K_{SSFA} = \frac{e^{a \cdot u} - e^{a \cdot l}}{a(u - l)}$$

The specific risk-weighting factor for the position (expressed as a percent) is

equal to $K_{SSFA} \times 100$.

Where:
p = 0.5.
K_G = Risk-based capital for structured securities is set at 0.08.
A = The attachment point for the position, which represents the threshold in which losses will be first allocated to the position and is expressed as a decimal value between 0 and 1.
D = The detachment point for the position, which represents the threshold in which credit losses of principal allocated to the position would result in the total loss of the position and is expressed as a decimal value between 0 and 1.

The proposed rule requires that:

If $D<K_A$ then K_{SSFA} is 1250%, if not then K_{SSFA} *1250%
If $A>K_A$ then K_{SSFA}*1250%,
If $A<K_A$ and $D>K_A$ then $[(K_A-A)/(D-A)*1{,}250\%]+[(D-K_A)/D-A)*1{,}250\%$

Utilizing the parameters above, the risk-weight is calculated. In addition to this calculation, a separate calculation is performed that divides the percentage of cumulative losses by the 8 percent statutory risk-based capital charge (K_G) for structured securities, including CMBS. This number is compared to Table 7 (the table number was from the December 21, 2011 proposed rule) to determine the applicable risk-weighting. Table 7 provides the floor level of risk-weighting. Consequently, if the risk-weighting assigned in Table 7 is higher than the preceding formula-based approach, the risk-weighting in Table 7 governs.

TABLE 7—MINIMUM SPECIFIC RISK-WEIGHTING FACTOR FOR A POSITION

Cumulative losses of principal on originally issued securities as a percent of K_G at origination		Minimum specific risk-weighting factor (in percent)
Greater than	Less than or equal to	
0	50	1.6
50	100	8.0
100	150	52.0
150	n/a	100.0

Analysis of the December 21, 2012 SSFA

Shown below are MBA's primary concerns with the SSFA formula:

Mature CMBS are Penalized

Over time, CMBS are expected to experience losses, which are reflected in the structure and subordination levels of CMBS. Due to risk-weighting assigned by Table 7, seasoned CMBS with strong overall performance may receive a higher risk-weighting than younger less seasoned CMBS due to normally occurring loan losses that accumulate over time. Consequently, the maturity level of a CMBS has the potential to have a greater impact on the risk-weighting than risk level of the underlying mortgages.

CMBS Subordination Levels are Not Taken Into Account

Table 7 does not take into consideration the amount of subordination of the CMBS. Consequently, for CMBS with subordination levels of 30 percent or greater ("highly subordinated CMBS") r, , even if losses reach 12 percent (the greater than 150 category on Table 7) dollar-for-dollar risk-based capital would be required, despite the fact that CMBS with this level of subordination are fully insulated from losses at the 12 percent level. This suggests that the subordination level of the CMBS should be taken into consideration when determining if the risk-weighting prescribed in Table 7 should be applied to a structured security.. MBA recommends when cumulative losses are less than the subordination level of the CMBS position (or another number representing a reasonable cushion, i.e. the subordination level plus 200 basis points), Table 7 should not be used for determining the floor risk-weighting.

Risk-Weighting Table is Not Granular

Table 7 provides broad loss categories with large risk-weighting increases from category to category. A modest increase in cumulative losses from 46 percent of K_A to 51 percent of K_A would result in an

increase from an 8 percent risk-weighing to a 52 percent risk-weighting, which represents over a 600 percent risk-weighting increase for only a 10 percent increase in the percent of cumulative losses. Consequently, the lack of granularity in Table 7 can trigger enormous increases in risk-weighting from small increases in cumulative losses. Similar to residential mortgages, the large increases in risk-weighting in Table 7 creates a cliff effect for this methodology.

The SSFA is Backward Looking

Since the SSFA relies on cumulative losses to set the SSFA floor, it looks to cumulative losses of the CMBS to determine the risk-weighting that does take into consideration the age of the CMBS. Because the age of the CMBS is not considered when establishing the risk-weighting floor, it has no predictive value for the future performance of the CMBS, i.e. average annual losses would provide a better indicator of how a CMBS was performing relative to its CMBS cohorts.