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Housing Finance & Regulatory Affairs

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Department of the Treasury
Office of the Comptroller of the Currency
250 E Street, S.W.
Mail Stop 2-3
Washington, D.C. 20219
Docket ID OCC-2012-0009; RIN 1557-AD46

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551
Docket ID FRS-2012-0250; RIN 7100-AD87

Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429
Docket ID FDIC 2012-0102; RIN 3064-AD97

Re: Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline; and Disclosure Requirements

Dear Sir or Madam:

The National Association of Home Builders (NAHB) appreciates the opportunity to provide comments on the above-referenced Joint Notice of Proposed Rulemaking (NPR) by the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Federal Reserve), and the Federal Deposit Insurance Corporation (FDIC) to implement Basel III regulatory capital standards in the United States. When finalized, the rules would establish the requirements for how much capital U.S. banking organizations must hold and how the required capital must be calculated by the banking organizations.

NAHB is a Washington-based trade association representing more than 140,000 members involved in all aspects of single family and multifamily residential construction, including the building, operation, and management of market rate and affordable rental properties. NAHB and its members have a strong interest in supporting a housing finance system that offers access to home buyers for affordable mortgage financing in all geographic areas and in all economic conditions.

NAHB's response to the NPR is focused on the components of the NPR that would have a significant impact on credit availability to home builders seeking financing to acquire and develop land and construct single family and multifamily residential properties and projects. Equally important to NAHB's members is the impact on the availability of credit to home buyers seeking mortgages to purchase homes. NAHB understands that adequate capital is critical to the safety and soundness of financial institutions; however, the amount of regulatory capital a bank is required to hold has a direct effect on the level of lending a bank is willing and able to accommodate. As discussed in our comments below, NAHB believes there are components of the NPR that would have a significantly negative impact on the type of loans and the amount of financing banks would offer in the future. NAHB is concerned that if the NPR is finalized in the current form, many banks would reduce, or eliminate altogether, lending to home builders and consumers seeking mortgage financing, with detrimental consequences for the housing market and the nation's economy.

BACKGROUND ON BASEL III

Basel III is widely acknowledged to be the reaction of the international banking regulators to the recent global banking crises caused in large part by some of the mortgage products that were originated in the U.S. and the ultimate performance of those mortgage products. Since the publication in 2010 of the latest version of the Basel Capital Accord by the international Basel Committee on Banking Supervision, the OCC, Federal Reserve, and FDIC (collectively, "the Agencies") have been drafting the regulations for its implementation in the U.S. In the intervening years, the U.S. has experienced many responses to the financial market meltdown, most notably the *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("the Dodd-Frank Act")*. The Dodd-Frank Act and the multitude of required regulations have been, in the view of many financial industry participants, a significant source of uncertainty for banks and the financial markets and a primary reason for the slow recovery in the nation's economy, including the job market and the housing market. The NPR incorporates relevant aspects of the Dodd-Frank Act.

The NPR proposes to revise the definition of capital and raise the minimum regulatory capital requirements for banking organizations. The NPR also recommends changes to the risk weights of several assets - in many cases subdividing an asset class into additional categories to more precisely align risk-weights to perceived risk.

The NPR consists of three proposed Regulatory Capital Rules:

- *Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action:* "Basel III" lays out how to calculate the capital required to determine the risk-based capital ratios. This proposal would apply to all banking organizations currently required to meet minimum risk-based capital requirements except for the small bank holding companies generally defined as those with under $500 million of consolidated assets.

- *Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements:* "Standardized Approach" details how to determine the total risk weights of a banking organization's on-balance sheet and off-balance sheet assets required to determine the risk-based capital ratios. This proposal would apply to the same banking organizations as Basel III.

- *Advanced Approaches Risk-based Capital Rule; Market Risk Capital Rule:* "Advanced Approaches" revises the current advanced approach risk-based capital rule and applies to the very largest and most complex banking organizations that are active internationally and already are bound by the advanced approach risk-based capital rule in effect since December 2007. *(Risk-Based Capital Standards: Advanced Capital Adequacy Framework - Basel II)*

The Basel III Regulatory Capital Rules were not intended originally to apply to all U.S. banks. However, the NPR makes it very clear the U.S. banking regulators have determined to apply Basel III and the Standardized Approach to all U.S. banking organizations subject to minimum capital requirements. This includes federal and state savings banks as well as bank holding companies other than small bank holding companies (generally, bank holding companies with consolidated assets of less than $500 million.) The Advanced Approach would continue to apply primarily to banking organizations with consolidated assets equal to or greater than $250 billion or with "on balance sheet" foreign exposures of at least $10 billion.

New minimum capital ratios would be effective beginning January 2013. Beginning January 1, 2015, banks would calculate risk weights per the new rules implementing the Standardized Approach. Full implementation of the Basel III Regulatory Capital Rules is not expected to be required until the end of 2018.

<u>NAHB POSITION ON BASEL III</u>

NAHB believes home builders would experience a direct, negative impact to their livelihoods if all banking organizations become subject to Basel III and the Standardized Approach as proposed in the NPR. NAHB's members are predominately small to mid-sized business owners who rely on banks as their primary source of financing. According to NAHB's *Survey on Acquisition, Development & Construction (AD&C) Financing* for the second quarter of 2012, 85 percent of single family home builders obtained construction financing from commercial banks and thrifts.

NAHB believes there are components of the proposed regulatory capital rules that would cause banks to restrict the type of loans and reduce the amount of financing they would offer in the future. The NPR would require banking organizations to hold excessive capital, reduce incentives to originate and/or own mortgages, increase compliance costs and burdens and generally make it more expensive for banks to lend. The end result would be less available and more expensive credit for home builders, home buyers and real estate development. If the NPR is finalized as currently put forward, NAHB believes many banks would be forced to reduce, or eliminate altogether, lending to small businesses, including home builders, and consumers seeking mortgage financing.

Home builders already are experiencing tight credit availability for AD&C financing. Increased regulatory pressure on commercial banks and savings and loan institutions to manage credit risk, increase reserves and reduce exposures on residential AD&C loans has exacerbated the credit crunch by contributing to banks' unwillingness to lend and their efforts to shrink outstanding AD&C portfolios. Consequently, builders nationwide are finding it extremely difficult to obtain approvals for loans on new projects and are facing adverse lender actions (unfavorable revisions of loan terms, equity calls and early repayment demands) on performing loans.

These trends are supported by NAHB's AD&C Financing Survey for the second quarter of 2012. The latest survey, with 300 respondents, shows that availability and terms of credit remain tight, although there are some signs of slight improvement:

- The net bank tightening index calculated from the AD&C survey indicated a slight tightening in bank lending on new loans from the first quarter. However, the index remains lower than at any point from 2007 – 2010. Overall, the second quarter 2012 survey showed some easing for new single-family construction loans, but that was more than offset by the tightening on new loans for land acquisition and multifamily condo construction.

- Of the builders and developers who reported availability of new financing had gotten worse since the first quarter of 2012, those reporting that lenders have "reduced the amount they are willing to lend" decreased to 66 percent from 73 percent. The next most commonly cited ways lenders tightened were: a) lowering the allowable LTV or loan-to-cost ratio (70 percent), b) not making new AD&C loans (70 percent), and c) requiring personal guarantees or collateral not related to the project (58 percent).

- In the second quarter of 2012, the percentage of respondents that reported they were putting land acquisition, development and single-family construction projects on hold until the financing climate was up in all categories. Fifty percent of respondents reported they were putting land acquisition projects on hold – up from 45 percent. Fifty-three percent reported they were putting land development projects on hold – up from 50 percent. Forty-four percent said they were putting single family construction projects on hold – up from 40 percent.

NAHB believes that the NPR as proposed would exacerbate the already tight lending conditions. Further, NAHB is very concerned that Basel III and the Standardized Approach are proposed to take effect at a precarious point in the economic recovery and, therefore, would have an immediate and detrimental effect on the future growth of the housing market and the economy as a whole. There is much evidence that a healthy housing market is critical to a strong economy and new home construction is a significant provider of jobs. NAHB's analysis shows that building 100 average single family homes generates 305 jobs.

Given the potentially negative impact of the NPR on credit availability and, more broadly, the economy, NAHB urges the Agencies to conduct further study and empirical analysis of the proposed rules on the real estate markets and the economy prior to implementing a final rule. Following the empirical studies, NAHB requests that the Agencies re-propose the NPR with a public comment period prior to implementing a final rule. NAHB believes these additional steps are necessary to carefully calibrate the proposed rules in order to reduce the potential for unintended and negative consequences on real estate markets and the U.S. economy.

Further, NAHB is particularly concerned about the impact of the NPR on community banks. According to Moody's Investors Service, "Construction lending has been the most meaningful business for small community banks. Small community banks with assets of $10 billion and less have about 21 percent of the entire banking system's assets, but about 48 percent of the system's construction loans as of 31 March 2012." [1] As noted, NAHB's members obtain the majority of their AD&C financing from banks, with the bulk of this from community banks. As discussed further below, NAHB believes the significant changes in the risk weights of a banking organization's assets proposed in the Standardized Approach from those required by the current, general risk-based capital rules followed by most banks today would have a very negative impact on community banks.

Therefore, NAHB urges the Agencies to exempt community banks from the Standardized Approach. The U.S. is not bound, either formally or informally, to adopt the Standardized Approach for non-internationally active U.S. banking organizations and until now, the U.S. banking regulators have declined to do so. It is fully within the discretion of the U.S. banking regulators, and fully consistent with the Basel framework, to continue to exempt certain U.S. banking organizations from the Standardized Approach or to make the application of such standards optional rather than mandatory.

NAHB also has several recommendations that would make the proposed capital rules more risk sensitive and more accurately reflect the actual risk of real estate lending activities. NAHB's key recommendations are summarized below and explained more fully in the detailed comments that follow. NAHB's recommendations primarily address concerns about reduced credit availability and affordability if the risk-weighting of assets in the Standardized Approach is adopted as proposed.

SUMMARY OF NAHB KEY RECOMMENDATIONS

- ***The Agencies should conduct further study and empirical analysis of the impact of the proposed rules on the real estate markets and the economy prior to implementing a final rule. The Agencies should re-propose the NPR following the empirical studies with a public comment period prior to implementing a final rule.***

- ***Community banks should be exempted from the Standardized Approach for Risk-weighted Assets. This proposed rule should apply only to the largest, most complex banking institutions. At most, the Standardized Approach should be optional rather than mandatory for community banks until the Agencies have studied the impact to the vast majority of community banks.***

- ***The new category of acquisition, development and construction loans, called High Volatility Commercial Real Estate (HVCRE), should be defined more specifically and should not capture as many commercial properties as proposed; additional risk mitigation measures should be allowed to reduce the number of commercial real estate properties classified as HVCRE.***

- ***Housing projects financed by low income housing tax credits (LIHTC) should be exempted from the definition of HVCRE.***

[1] Moody's Investors Service, Inc. *Weekly Credit Outlook*, June 11, 2012.

- ***Pre-sold construction loans should receive a 50 percent risk weight when meeting the specified criteria from the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act (RTCRRI Act) or the regulatory requirements of the Federal Reserve. Criteria proposed in the Standardized Approach are too restrictive.***

- ***The proposed risk weights of residential mortgages should be reconsidered based on empirical data that demonstrate a relationship between the credit risk of the mortgage and the risk weight assigned to the mortgage.***

- ***Ability to Repay and Qualified Mortgage (QM) should set the standards for mortgage lending, not the Agencies' proposed Category 1 and Category 2 mortgage definitions.***

- ***Junior liens should receive the same risk weight regardless of whether they are held by the same banking organization that holds the first lien or a third party banking organization.***

- ***All modified and restructured mortgages should receive the same treatment as HAMP mortgages.***

- ***The risk weight on HVCRE, pre-sold construction, and statutory multifamily loans should not increase to 150 percent when these loans become 90-day delinquent or on nonaccrual.***

- ***Mortgage Insurance should continue to be allowed as a risk mitigation tool and be allowed to reduce a mortgage's loan-to-value for purposes of determining the mortgage's risk weight.***

- ***Banking organizations should not be required to hold capital against credit-enhancing representations and warranties (reps and warranties) if the reps and warranties do not exceed 120 days or if the reps and warranties are for the return of assets in instances of fraud, misrepresentation or improper documentation.***

PROPOSED CAPITAL TREATMENT OF SPECIFIC REAL ESTATE ASSETS

The Standardized Approach proposed by the Agencies revises the risk weights of several asset classes common to banking organizations. In many cases, banking organizations will be required to hold more capital in reserves against these assets as a precaution against credit losses. NAHB is concerned that the combined effect of compliance with burdensome calculations, due diligence and reporting requirements, and increased capital will have a negative impact on the availability and affordability of credit to all borrowers by making it more difficult and less profitable for banking organizations to lend. NAHB believes the treatment of the assets discussed below will be particularly harmful to home builders, home buyers, home owners, and developers of multifamily and light commercial properties.

1. Acquisition, Development & Construction Loans [2]

Current Risk Weight

Under current, general risk-based capital rules, loans to builders for acquisition, development and construction (AD&C), except pre-sold construction loans (discussed below), are assigned the risk weight of 100 percent. For certain loans, under the NPR, this risk weight will not change. AD&C loans financing projects that meet the criteria below will continue to receive a 100 percent risk weight:

1) One-to-four-family residential property; or
2) Commercial real estate projects in which:
    - The loan-to-value ratio is less than or equal to the applicable maximum supervisory LTV ratio in the agencies' real estate lending standards;
    - 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**
    - The borrower contributed the amount of capital required per the above before the banking organization advances funds under the financing contract, 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 loan is converted to permanent financing or is sold or paid in full.
    - Permanent financing by the bank must conform to the bank's underwriting criteria for long-term commercial mortgage loans.

Proposed Risk Weight

In considering regulations to implement the Standardized Approach, the Agencies have determined that a certain subset of AD&C loans present a "unique" risk to banking organizations and should require a higher risk weight than 100 percent. High Volatility Commercial Real Estate (HVCRE) was incorporated in the Advanced Capital Adequacy Framework - Basel II, issued December 2007 for core banks defined as those with consolidated total assets of $250 billion or more or with consolidated total on-balance-sheet foreign exposure of $10 billion or more. The Agencies propose to require all banking organizations to categorize AD&C loans as HVCRE loans if they finance projects that do not meet the above criteria. HVCRE exposures will be assigned a risk weight of 150 percent.

NAHB Comments and Recommendations

NAHB appreciates that the Agencies have maintained the 100 percent risk-weight for 1-4 family residential properties and commercial real estate loans meeting certain underwriting criteria.

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[2] NAHB is a signatory to a Real Estate Associations' comment letter to the Agencies which has more detailed recommendations on commercial and multifamily issues.

These AD&C lending categories are most important to the NAHB membership, and it demonstrates that the Agencies recognize that commercial real estate presents different levels of risk based on the type of project and the LTV. However, NAHB has specific concerns regarding the proposed category of HVCRE financing and the recommended 150 percent risk-weight for HVCRE loans. The more AD&C loans that can utilize the 100 percent risk weight, the less negative impact the new regulations will have on home builders and builders of mixed use properties.

Definition of HVCRE

At a minimum, NAHB requests the Agencies to clarify the specific types of financings that will fall under the HVCRE category, rather than defining HVCRE as financings that do not meet the criteria for the 100 percent risk weight. Pending this clarification, NAHB is concerned that the HVCRE category encompasses too many commercial properties and the exclusions should be expanded – taking into account several mitigating factors that would reduce the risk of these financings. In particular, NAHB recommends excluding completed, income-earning loans. Once the underlying property has been completed and is ready for tenant use, expenditures shift from construction costs to tenant improvements and building operations, and risk substantially decreases from development risk to cash flow risk.

Borrower-Contributed Capital

NAHB believes the 15 percent equity required from the borrower by the banking organization should not be limited to cash equity or unencumbered readily marketable assets in order to be exempt from the HVCRE classification and receive the 100 percent risk weight. Commercial borrowers contribute to an AD&C project in a variety of ways that reduce the risk to the lender. Some borrowers negotiate the value of the land toward equity; some lenders accept irrevocable standby letters of credit. Per the Agencies' current uniform rule on real estate lending standards *other acceptable collateral* means any collateral in which the lender has a perfected security interest, which has a quantifiable value, and is accepted by the lender in accordance with safe and sound lending practices. NAHB requests that the Agencies continue to allow other acceptable collateral as contributed capital to a project.

Any re-proposed rule should recognize the value of land contributed by the borrower. Like borrower-contributed cash, borrower-contributed land increases the borrower's equity in the investment, reduces the loan amount, and reduces the banking organization's risk in the project. As with other acceptable collateral, recognition of borrower-contributed land would allow creditworthy borrowers that have low levels of readily available cash to finance projects that would grow the economy.

NAHB also believes that banking organizations should be able to consider a contract to purchase the property or a pre-leasing contract as borrower-contributed capital. Both types of contracts guarantee future income for the borrower, thereby reducing repayment risk and default risk for the banking organization. Moreover, recognition of contracts to purchase and pre-leasing contracts would permit creditworthy borrowers to develop useful projects and allow investors and businesses to buy into such projects at a low cost in their early stages.

NAHB also suggests that a re-proposed rule should calculate borrower-contributed capital as a percentage of the estimated costs of the project rather than the "as completed" value. As proposed, borrowers are required to contribute capital "of at least 15 percent of the real estate's appraised 'as completed' value." This proposed approach would be difficult to implement because the "as completed" value could not be appraised until the project is completed. This would result in regulatory uncertainty and possible over-collateralization by the borrower. By contrast, both the bank and the borrower estimate development and project costs at the beginning of the project—the same time as when the borrower contributes capital. The Agencies therefore should replace the clause "the real estate's appraised 'as completed' value" to read "the estimated total development costs through completion of construction and stabilization as approved by the lender." Replacing "as completed" value with the "estimated costs" standard is both more conservative and more practical to implement.

Low Income Housing Tax Credit Projects

NAHB also recommends that properties financed by Low Income Housing Tax Credits (LIHTCs) be exempted from the definition of HVCRE. Such properties should be exempted from the definition of HVCRE because the high 150 percent risk weight for HVCRE overstates the risk of LIHTC projects. Moreover, the punitive risk weight would directly undermine public policy in favor of such projects.

The LIHTC is an indirect federal subsidy used to finance the development of affordable rental housing for low-income households. LIHTC awards require that property owners accept and maintain ongoing restrictions on tenant rental rates. Those rental restrictions reduce projected net operating incomes, and therefore reduce the appraised values of those projects. Lower appraised values increase LTV ratios and would drive a higher percentage of these projects into the proposed HVCRE category. Additionally, borrower-contributed capital for these projects often include "soft pay" subordinated debt from public sector sources (*i.e.*, debt repayable only to the extent of excess cash flow, if any) or donated land from public sector sources—neither of which complies with the proposed definition of upfront equity for purposes of the exemption from HVCRE.

NAHB believes treatment of LIHTC projects as HVCRE is unwarranted. These projects pose little market risk, and historic performance patterns have not been volatile. The same downward pressure on rent and property values makes such properties attractive for renters. Additionally, many LIHTC projects have pre-committed, permanent take-out financing committed up front to mitigate repayment risk. Moreover, other federal statutes and regulations, such as the Community Reinvestment Act, encourage use of the LIHTC Program to promote affordable, low-income housing. By contrast, the proposed HVCRE rules discourage the use of LIHTC, or at the very least, increase the cost of such projects.

In light of these characteristics, NAHB requests the Agencies exempt LIHTC projects from the definition of HVCRE. A 100 percent risk weight is more appropriate given the policy objectives in favor of LIHTC projects and the low risk profile of such projects. This change also would be consistent with the proposed treatment of community development equity exposures at a 100 percent risk weight.

2. Pre-Sold Construction Loans

Current Risk Weight

Under the current, general risk-based capital rules, the risk weight of pre-sold construction loans made to home builders to finance 1-4 family residences is 50 percent if the loans meet certain criteria. In the event the home buyer terminates the sales contract, the risk-weight of the construction loan must increase to 100 percent. These risk weights are mandated by section 618 (a) (1) or (2) of the RTCRRI Act; however, the Act specifically required each federal banking regulator to establish its own criteria for the specified risk weights as long as the criteria included the requirements of the Act.

Proposed Criteria for 50 percent Risk Weight

The proposed Standardized Approach lists the specific underwriting, earnest money deposit and documentation conditions that a bank would be required to meet in order to assign the 50 percent risk weight to pre-sold construction loans for 1-4 family residences. The criteria are intended to provide the bank assurance that the home has been sold to a qualified buyer who intends to occupy the home. The requirements proposed by the Agencies incorporate the current statutory requirements from the RTCRRI Act as well as criteria from the individual Agencies. The criteria recommended in the Standardized Approach (below) are identical to the current requirements of the OCC and the FDIC published in the Code of Federal Regulations for pre-sold construction loans. The Federal Reserve is less specific.

The Standardized Approach would require:

1) The loan is made in accordance with prudent underwriting standards;
2) The purchaser is an individual(s) that intends to occupy the residence and is not a partnership, joint venture, trust, corporation, or any other entity (including an entity acting as a sole proprietorship) that is purchasing one or more of the residences for speculative purposes;
3) The purchaser has entered into a legally binding written sales contract for the residence;
4) The purchaser of the residence has a firm written commitment for permanent financing of the residence upon completion;
5) The purchaser has made a substantial earnest money deposit of no less than three percent of the sales price, which is subject to forfeiture if the purchaser terminates the sales contract; provided that, the earnest money deposit shall not be subject to forfeiture by reason of breach or termination of the sales contract on the part of the builder;
6) The earnest money deposit must be held in escrow by the banking organization or an independent party in a fiduciary capacity, and the escrow agreement must provide that in the event of default the escrow funds shall be used to defray any cost incurred by the banking organization relating to any cancellation of the sales contract by the purchaser of the residence;
7) The builder must incur at least the first 10 percent of the direct costs of construction of the residence (that is, actual costs of the land, labor, and material) before any drawdown is made under the loan;
8) The loan may not exceed 80 percent of the sales price of the presold residence; and
9) The loan is not more than 90 days past due, or on nonaccrual.

If the home buyer terminates the sales contract, the banking organization must immediately apply a 100 percent risk weight to the loan and report the revised risk weight in the banking organization's next quarterly regulatory report.

NAHB Comments and Recommendations

The statutory requirements for risk-weights that are published in the RTCRRI Act specify that the "appropriate Federal regulator" may impose additional documentation, deposit and underwriting requirements for pre-sold construction loans receiving the 50 percent risk-weight classification. Banking organizations are required to follow the risk-based capital directives issued by their regulator. Banking organizations regulated by the OCC and the FDIC already are required to meet the conditions proposed in the Standardized Approach for pre-sold construction loans if they want to utilize the 50 percent risk weight. Banking organizations regulated by the Federal Reserve have only to meet the following criteria:

1) Builder has "substantial" project equity for the construction;
2) 1-4 family residences have been presold under firm contracts to purchasers who have obtained firm commitments for permanent qualifying mortgage loans;
3) Purchasers have made "substantial" earnest money deposits;
4) Bank holding company has obtained sufficient documentation that the buyer of the home intends to purchase the home (i.e., has a legally binding written sales contract);
5) All other loans receive 100 percent risk weight.

NAHB recommends that the Standardized Approach should adopt the above requirements of the Federal Reserve for pre-sold construction loans to be assigned a 50 percent risk weight. NAHB is concerned that banking organizations regulated by the OCC and the FDIC may already be following the less restrictive regulations of the Federal Reserve and therefore applying a 100 percent risk weight to these loans as they do not meet their federal regulators' criteria for a 50 percent risk-weighting. If all banking organizations are required to follow the stricter criteria under the proposed Standardized Approach, this will further restrict already tight lending conditions for pre-sold construction loans. NAHB believes if the Agencies apply uniform regulations that permit banks to implement the Federal Reserve criteria for 50 percent and 100 percent risk weight, this would help to ease credit availability for pre-sold construction loans without significantly increasing risk to banking organizations.

3. Statutory Multifamily Mortgages

Current Risk Weight

Under the current, general risk-based capital rules, the risk weight for loans on multifamily residential properties is 50 percent if the loans meet certain criteria. If the loans fall outside the criteria, the risk-weight is 100 percent. The risk weight and the criteria are mandated by the RTCRRI Act.

Proposed Criteria for 50 percent Risk Weight

The proposed Standardized Approach lists the specific underwriting and documentation requirements that a bank must meet in order to apply the 50 percent risk weight to multifamily residential mortgages. The requirements mirror the current statutory requirements from the

RTCRRI Act as well as the criteria established by each federal banking regulator per the Act. The criteria from the proposed rule below are identical to the current requirements specified by OCC, FDIC and the Federal Reserve.

1) The loan is made in accordance with prudent underwriting standards;
2) LTV does not exceed 80 percent (75 percent if the interest rate is adjustable over the term of the loan);
3) All principal and interest payments on the loan must have been made on time for at least one year prior to applying the 50 percent risk weight to the loan, or in the case where an existing owner is refinancing a loan on a 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;
4) Amortization of principal and interest must occur over a period of not more than 30 years and the original maturity for repayment of principal is not less than seven years;
5) 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 debt service (or 115 percent of current annual debt service if the loan is based on an interest rate that changes over the term of the loan). In the case of a cooperative or other not-for-profit housing project, the property must provide sufficient cash flow to provide a comparable protection to the banking organization;
6) The loan is not more than 90 days past due, or on nonaccrual.

A multifamily residential mortgage will remain subject to a 50 percent risk weight if it meets the specified criteria and a 100 percent risk weight if it falls outside the specified criteria. A newly originated construction loan for a multifamily property would be subject to a 100 percent risk weight. The criteria are unchanged from that specified by the Agencies in the Code of Federal Regulations.

NAHB Comments

NAHB is pleased that the Agencies have not proposed changes to the risk weight and the required criteria for statutory multifamily mortgages.

4. Residential Mortgage Loans (Includes Restructured/Modified Loans, Second Liens and Home Equity Lines of Credit)

Current Risk Weight

Under the current, general risk-based capital rules, residential, first-lien mortgages, prudently underwritten, owner-occupied or rental and current or less than 90-days past due receive a risk weight of 50 percent. All other loans receive a 100 percent risk weight.

Stand-alone, junior-lien residential mortgages and home equity lines of credit are assigned a 100 percent risk weight.

Modified or restructured residential mortgages are assigned a 100 percent risk weight.

<u>Proposed Risk Weight</u>

The proposed Standardized Approach would risk-weight residential, single family mortgages based on LTV ratios and product features, with the intent of increasing the risk sensitivity per loan. The Agencies have proposed two categories of loans and risk weights based on the type of mortgage product, LTV ratio and loan category. Risk weights will range from 35 percent to 200 percent. The changes are particularly significant for loans that do not fit into a Category 1 mortgage as defined by the Agencies.

<u>Category 1</u> mortgages are defined using the following criteria:

1) The duration of the mortgage exposure does not exceed 30 years;
2) The terms of the mortgage provide for regular periodic payments that do not: (i) result in an increase of the principal balance; (ii) allow the borrower to defer repayment of principal of the residential mortgage exposure; or (iii) result in a balloon payment;
3) The standards used to underwrite the mortgage: (i) took into account all of the borrower's obligations including, for mortgage obligations, principal, interest, taxes, insurance (including mortgage guarantee insurance), and assessments; and (ii) resulted in a conclusion that the borrower is able to repay the mortgage using: (a) the maximum interest rate that may apply during the first five years after the date of the closing of the mortgage; and (b) the amount of the residential mortgage that is the maximum possible contractual exposure over the life of the mortgage as of the date of the closing of the transaction;
4) The terms of the mortgage allow the annual rate of interest to increase no more than two percentage points in any twelve-month period and no more than six percentage points over the life of the exposure;
5) For a first-lien home equity line of credit (HELOC), the borrower must be qualified using the principal and interest payments based on the maximum contractual exposure under the terms of the HELOC;
6) The determination of the borrower's ability to repay is based on documented, verified income;
7) The mortgage is not 90 days or more past due or on non-accrual status; and
8) The mortgage is (i) not a junior-lien residential mortgage and (ii) if the residential mortgage is a first-lien mortgage held by a single banking organization and secured by first and junior lien(s) where no other party holds an intervening lien, each mortgage must have the characteristics of a Category 1 mortgage as set forth in this definition.

<u>Category 2</u> mortgages are defined as any mortgage that is not a Category 1 mortgage. Category 2 loans are considered more risky and would be assigned a minimum 100 percent risk weight.

Table A shows the proposed risk weights based on LTV ratios and Category of the loan:

Table A

Loan-to-Value Ratio (In percent)	Category 1 Residential Mortgage Exposure (In percent)	Category 2 Residential Mortgage Exposure (In percent)
Less than or Equal to 60	35	100
Greater than 60 and less than or equal to 80	50	100
Greater than 80 and less than or equal to 90	75	150
Greater than 90	100	200

Proposed Risk Weight of Junior Liens

Under the proposed Standardized Approach, a bank could classify a junior lien as a Category 1 residential first mortgage and use the Category 1 risk weights based on the combined LTV only if the bank holds both the first mortgage 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. In these instances, the LTV would be determined using the unpaid principal balance of the first lien and the maximum contractual principal balance, i.e., the funded plus unfunded amount of the junior lien.

All other junior liens are classified as Category 2 mortgage loans – and subject to the increased risk weight requirements. Effectively, under the proposed Standardized Approach, a banking organization that holds a first and junior lien would hold capital for both loans at the Category 2 level, even if only one of the loans is a Category 2 loan. If a third party holds the junior lien, there is no impact to the asset weight of the first lien although the third party must calculate the capital requirement based on the combined LTV and using the Category 2 risk weight.

Proposed Risk-Weight for Home Equity Lines of Credit

The proposed Standardized Approach generally would treat home equity lines of credit as Category 2 loans with risk weights ranging from 100 percent to 200 percent.

Proposed Risk Weight of Modified or Restructured Mortgage Exposures

The proposed Standardized Approach would require banks to re-categorize a modified or restructured mortgage as a Category 1 or Category 2 mortgage in accordance with the terms and characteristics of the mortgage after the modification or restructuring using an updated LTV ratio at the time of the modification or restructuring.

Residential mortgages modified or restructured on a permanent or trial basis solely pursuant to the U.S. Treasury's Home Affordable Mortgage Program (HAMP) would not be considered restructured or modified under the proposed requirements and would receive the Category 1 risk weight provided in Table A.

NAHB Comments and Recommendations

NAHB appreciates that the Agencies are trying to calibrate the risk exposure of regulated banking organizations based on the perceived risk of their assets. However, NAHB believes the Agencies have proposed changes to the risk weights of residential mortgages without having empirical data to demonstrate the relative risk of the mortgage product and the LTV to which the risk weight is assigned – making the risk-weights appear arbitrary.

Without empirical evidence that banking organizations incur the relative level of risk on Category 1 mortgages assumed by the Agencies per the proposed risk weights, NAHB believes the risk weights for Category 1, residential, first-lien mortgages should remain at the current risk weight of 50 percent. Category 1 mortgages should not exclude all balloon payment mortgages and mortgages with interest-only features. These loans, prudently underwritten, serve a need in the market and can be useful for some home buyers. Balloon mortgages, in particular, are often originated by community banks and held in their portfolios. If the proposed rules are adopted, balloon mortgages would be Category 2 loans and community banks would be limited in the number of balloon mortgages they could offer due to the extremely high risk-weights assigned to Category 2 mortgages.

NAHB also believes eliminating a bank's ability to risk-weight by asset class and instead requiring the bank to risk-weight individual loans by LTV and mortgage product will be a very resource-intensive endeavor and make it extremely burdensome for many community banking organizations to comply. Also, as proposed, the risk weights for each mortgage will need to be continually re-evaluated for changes in collateral value – adding another level of complexity and cost.

Treatment of Junior Liens

NAHB believes junior liens should be treated the same whether they are held by the banking organization that holds the first lien or a third party banking organization. The potential that a bank holding both the first and junior liens may be required to risk weight both loans as Category 2 loans will prohibit community banks from making junior liens and thereby eliminate a profitable and service-oriented product for their customers. A third-party bank would have to hold capital on the combined loan amount at 100 to 200 percent Category 2 risk weight making it a less attractive for any banks to originate junior liens.

As proposed, the risk weights of junior liens are disproportionately high when compared with other types of collateralized and non-collateralized loans and raise concerns about the future availability and cost of these products. NAHB, therefore, requests that the Agencies reconsider the proposed treatment of junior liens.

Treatment of Modified or Restructured Residential Mortgages

NAHB agrees with the statement in the preamble to the Standardized Approach that mortgage modifications and restructurings "can be an effective means for a borrower to avoid default and foreclosure and for a banking organization to reduce risk of loss." Therefore, NAHB believes all modified and restructured mortgages should receive the same treatment as HAMP mortgages.

Cumulative regulatory impacts

Currently, other industry regulators are considering mandates to define residential mortgages within a consistent, transparent framework. Specifically, the Consumer Financial Protection Bureau (CFPB) is required by the Dodd-Frank Act to establish a nationwide Ability to Repay standard that includes defining a "qualified mortgage" (QM). The Ability to Repay standard requires lenders to ensure that all residential mortgage borrowers have an ability to repay their mortgage loan at the time of origination. The standard will provide the blueprint for all residential mortgage underwriting criteria and is intended to eliminate mortgage product features and underwriting practices that are deemed risky and resulted in the extensive industry losses during the financial crisis. The CFPB has indicated that it will release a final Ability to Repay standard by early 2013.

Once the CFPB has finalized the QM definition, all residential mortgage loans will have to meet the ability to repay standard. Since the Agencies have included the Ability to Repay standard as a key criterion for Category 1 mortgages, NAHB believes in *concept* that the Agencies should include all U.S. residential loans that meet the QM definition as Category 1 mortgages. However, NAHB emphasizes that the CFPB has not released a final rule, and many questions remain as to how the final rule will impact mortgage lending. NAHB has significant concerns about how the CFPB will define a QM and, therefore, we believe it is premature and inconsistent for the Agencies to propose a unique and separate set of guidelines for mortgage lending before the Ability to Repay and QM rules have been finalized.

5. Past Due Exposures

Current Risk Weight

Residential mortgage loans, 1-4 family pre-sold construction loans and statutory multifamily loans move to a 100 percent risk weight from a 50 percent risk weight when a loan becomes 90-days or more past due or is on nonaccrual. For all other real estate loans, the risk weight does not change when the loan becomes 90-days or more past due or is on nonaccrual.

Proposed Risk Weight

The Standardized Approach proposes to increase the risk weight for all loans that become past due. The Standardized Approach assumes mortgages and financings that reach 90-days past due present additional credit risk to banks. Accordingly, for all loans that become 90-days past due or on nonaccrual, except residential mortgages loans that are not guaranteed or not secured (and not a sovereign exposure), the proposed rule recommends a risk weight of 150 percent.

- *90-Days Past Due Risk Weight for Residential Mortgage Loans*

  The Standardized Approach recommends that a residential mortgage that is 90-days past due must be classified as a Category 2 loan and risk-weighted according to the applicable loan to value risk weight.

- *90-Days Past Due Risk Weight for HVCRE and Non-HVCRE Loans*

  The Standardized Approach proposes that AD&C financings that become 90-days past due will be assigned a risk weight of 150 percent to reflect increased risk. This will apply to both non-HVCRE and HVCRE financings.

- *90-Days Past Due Risk Weight for Pre-Sold Construction Loans*

  The Standardized Approach proposes that a pre-sold construction loan that becomes 90 days or more past due or on nonaccrual will be assigned a 150 percent risk weight to reflect increased risk. Currently, a pre-sold construction loan that is 90 days or more past due or on nonaccrual will be assigned a 100 percent risk weight due to the fact that it has fallen outside the criteria for the 50 percent risk weight category.

- *90-Days Past Due Risk Weight for Multifamily Statutory Loans*

  The Standardized Approach proposes that a statutory multifamily mortgage 90 days or more past due or on nonaccrual will be assessed a 150 percent risk weight to reflect increased risk. Currently, a multifamily mortgage that is 90 days or more past due or on nonaccrual will be assessed a 100 percent risk weight due to the fact that it has fallen outside the criteria for the 50 percent risk weight category.

NAHB Comments and Recommendations

NAHB is concerned about the significant increase in the risk weight the Agencies have proposed for loans that become 90-days past due or on nonaccrual. In particular, NAHB believes if banks are compelled to increase the risk weight of HVCRE, pre-sold construction, and statutory multifamily loans to 150 percent when they become 90-days delinquent, this will create a disincentive for the banks to work with builders to restructure a loan, choosing to foreclose rather than tie up additional capital.

Also, when a loan becomes delinquent, the banking organization increases the loan loss reserves held against that loan. This is an accounting practice separate from holding capital reserves required under the risk-based capital regime, but essentially it is intended to perform the same function of ensuring the bank can absorb potential losses on the asset as the risk of loss is increased. Holding both additional risk-based capital and increased loan loss reserves for past due loans, effectively results in holding loss-absorbing capital twice against the very same loans. NAHB does not believe this is an efficient use of capital and unnecessarily reduces the availability of capital for more productive purposes.

6. Mortgage Insurance

Current Treatment

Under the current, general risk-based capital rules banking organizations recognize private mortgage insurance (MI) as an offset to a bank's exposure when calculating the LTV of a mortgage.

Proposed Treatment

The Agencies believe it would not be prudent to continue to recognize MI for purposes of determining the LTV of a mortgage due to the varying degrees of financial strength of the MI providers.

NAHB Comments and Recommendations

NAHB believes private MI continues to offer valuable credit risk mitigation to mortgage lenders who, in turn, pass along the value to home buyers in the form of lower interest rates and lower downpayments. NAHB understands the Agencies are concerned about the financial soundness of the individual mortgage insurers and the industry generally, but NAHB is opposed to eliminating altogether the use of MI as a risk mitigation tool. For many years, MI has provided consumers access to well-underwritten, lower downpayment loans, making homeownership a reality for many low- and moderate-income families. Private MI also provides many benefits to the housing finance industry, including shared risk in the event of mortgage default and foreclosure and an additional and independent underwriting evaluation. Existing data reveal that loans carrying MI experience lower default rates due largely to this additional underwriting step in the origination process.

NAHB urges the Agencies to work with the housing finance industry and the mortgage insurers to develop a calculation that would indicate the circumstances under which a banking organization would be allowed to incorporate MI in the LTV determination for purposes of assigning the risk weight of a residential mortgage.

7. Credit Enhancing Representations And Warranties

The FDIC defines credit-enhancing representations and warranties (reps and warranties) as reps and warranties that are made or assumed in connection with a transfer of assets (including mortgage servicing assets) and that obligate a bank to protect investors from losses arising from credit risk in the assets transferred or the loans serviced. Credit-enhancing reps and warranties include promises to protect a party from losses resulting from the default or nonperformance of another party or from an insufficiency in the value of the collateral that are made or assumed in connection with a transfer of assets (including mortgage servicing assets) and that obligate a bank to protect investors from losses arising from credit risk in the assets transferred or the loans serviced.

Credit-enhancing reps and warranties are considered off-balance sheet items and to determine risk-weight an off-balance sheet item is converted to the equivalent of an on-balance sheet value by using a Credit Conversion Factor (CCF).

Current CCF for Credit Enhancing Representations and Warranties

Under the current general risk-based capital rules, a banking organization holds risk-based capital against assets sold to a third-party if the banking organization provides credit-enhancing reps and warranties to the investor or purchaser of the asset. However, for purposes of holding risk-based capital, the current rules do not consider the following to be credit-enhancing representations and warranties: 1) clauses and similar warranties that require the seller to take back the mortgage in the case of an early payment default; 2) certain premium refund clauses that cover assets guaranteed, in whole or in part, by the U.S. government, a U.S. government agency, or a U.S. government-sponsored enterprise, provided the premium refund clauses are for a period not to exceed 120 days from the date of transfer; or, 3) warranties that permit the return of assets in instances of fraud, misrepresentation or incomplete documentation. For these specific representations and warranties, a seller is not required to retain capital once the asset has transferred.

Proposed CCF

The Standardized Approach recommends that in cases where a banking organization provides credit-enhancing reps and warranties on assets sold to a third party, including early payment default clauses and premium refund clauses on mortgage loans, the seller must calculate and hold capital against the transferred asset while the credit enhancing arrangement is in place. The Agencies propose a 100 percent CCF on exposures with these credit enhancing reps and warranties.

The Agencies do not make it clear whether credit-enhancing reps and warranties that permit the return of assets in instances of fraud, misrepresentation or incomplete documentation will be captured under the proposed change. Nor do the Agencies make it clear whether the current exemption for reps and warranties that are limited to 120 days will remain in place.

Making this proposed requirement even more onerous, the Federal Housing Finance Agency (FHFA) recently announced that beginning in January 2013, any mortgages "funded, acquired, securitized or guaranteed" by Fannie Mae and Freddie Mac (the Enterprises) will be subject to a new reps and warranties framework that will automatically trigger a repurchase demand if a borrower fails to make full payments on his or her mortgage for three months after the date the mortgage was acquired by one of the Enterprises. This appears to qualify as a credit-enhancing rep and warranty under the proposed rules and would require a banking organization to hold capital at a 100 percent CCF for the full amount of the exposure on all mortgages sold to the Enterprises for at least 120 days. Prior to this recent change, loans sold to the Enterprises did not have a first-payment default repurchase clause, and banks selling loans to the Enterprises would not have been subject to the new capital charge.

NAHB Comments and Recommendations

NAHB recommends that the Agencies maintain the existing exemption from the 100 percent CCF on credit-enhancing reps and warranties that do not exceed 120 days. A primary use of this rep and warranty is for newly originated mortgage loans sold on the secondary market and would protect lenders from holding capital against new loans sold to the Enterprises with the recent repurchase trigger. The percent of first payment or early payment defaults historically has been quite small, and this proposed risk-weight seems proportionally out of balance. If banks are required to hold capital for mortgages with this temporary 120-day rep and warranty, while only short-term, NAHB is concerned about the impact on community banks that rely on getting these loans off their books immediately to avoid holding regulatory capital. This could be a major deterrent to mortgage originations for some banking organizations.

Another reason to for the Agencies to consider eliminating the proposed risk-weight for credit-enhancing reps and warranties for first payment defaults is to eliminate the impact of two banking organizations holding capital against the same assets at the same time. While the seller is holding capital against the asset, so is the purchaser. Not only will this be a direct hit to individual banking organizations, but it pulls even more capital away from other productive opportunities.

Further, NAHB requests clarification that the Agencies do not intend for banking organizations to hold capital at 100 percent CCF against assets with reps and warranties that permit the return of assets in instances of fraud, misrepresentation or incomplete documentation. Any possibility that warranties for fraud, misrepresentation, or incomplete documentation would be subject to capital charges would have a dramatic, detrimental impact on banks' capital ratios because such reps and warranties remain in effect for the entire life of the loan. If these reps and warranties were suddenly subject to capital charges, this could cause an enormous increase in risk-weighted assets and a large drop in capital ratios for some community and regional banks. NAHB therefore believes it is critical for the Agencies to state specifically that such reps and warranties are not subject to capital charges.

8. Performance Bonds And Unfunded Commitments

FDIC's definition of *Commitments to Fund Loans Secured by Real Estate* includes the unused portions of commitments to extend credit for the specific purpose of financing commercial and multifamily residential properties and the unused portions of commitments to extend credit for the specific purpose of financing land development provided such commitments, when funded, would be reported on the Call Report as loans secured by real estate in "Construction and Land Development."

The face amount of certain off-balance sheet items such as unfunded commitments, performance bonds, standby letters of credit and others are converted to risk weight assets using a two-step process. The face amount of the off-balance sheet item is first multiplied by the assigned "credit conversion factor" (CCF) and this amount is assigned to the risk weight.

Current Credit Conversion Factors

- 50 percent for performance bonds and standby letters of credit.
- 100 percent for financial standby letters of credit.
- 0 percent for the unfunded portion of a commitment that has an original maturity of one year or less **or** is unconditionally cancellable at any time.
- 50 percent for the unused portion of a commitment that has an original maturity of more than one year and is not unconditionally cancellable at any time.

Proposed Credit Conversion Factors

For commitments not secured by one-to-four family homes:

- If the commitment is unconditionally cancellable by the bank then no risk weighting is needed.
- If the commitment is not unconditionally cancellable by the bank and the original maturity is one year or less, the risk weighting is 20 percent of the commitment. (This is up from zero today.)

- If the commitment is not unconditionally cancellable by the bank and the original maturity is greater than one year, the risk weighting is 50 percent of the commitment. (This would be unchanged from today.)

NAHB Comments and Recommendations

NAHB appreciates that for unfunded commitments that are not unconditionally cancellable by the bank and the original maturity is greater than one year, the risk-weight of the unfunded portion of the commitment remains at 50 percent. This is an important tool for home builders that use lines of credit when developing and building projects.

IMPACT TO COMMUNITY BANKS

The banking industry has expressed strong concerns that the Proposed Rules will have a significant impact on community banks. NAHB shares these concerns. There are certain banking operations that are handled differently by community banks than by larger, more complex banking organizations. The Agencies have done analysis on the economic impact of Basel III and the Standardized Approach on small banking organizations. In this analysis, "small entity" includes a depository institution, bank holding company, savings and loan holding company, national bank, and federally chartered savings association with total assets of $175 million or less. The Agencies assessed whether these banking organizations would be required to raise additional capital and whether they would incur increased expenses to hire and train additional personnel in order to comply with the capital changes and increased reporting requirements.

According to ICBA, there are more than 7,000 community banks in the United States, including commercial banks, thrifts, and stock and mutual savings institutions. Of these institutions, approximately 33 percent or 2,310 have assets under $100 million; approximately 91 percent or 6,370 have assets under $1 billion. While it is hard to determine precisely how many banks are not included in the Agencies' assessment of the projected impact of Basel III and the Standardized Approach on small entities, it appears the effect on a large percentage of banks meeting the traditional definition of a community bank has not been considered.

NAHB believes it is critical for the Agencies to assess how community banks with total assets between $175 million and $1 billion, i.e., the vast majority of community banks, would be impacted prior to implementing the NPR.

NAHB believes the approach taken in the NPR to each of the following balance sheet items will have unintended consequences to the viability of many community banks and will lead to the reduced availability of affordable credit.

1. Residential Mortgage Loans

The Agencies' proposed revisions to the risk weights of residential mortgage products will make it difficult or impossible for community banks to continue offering the products and services that best meet the unique needs of their communities. As an example, community banks often use balloon mortgages when lending in their local communities – usually keeping these loans in portfolio. The rules propose to risk-weight mortgages with balloon payments, depending on the LTV, at no less than 100 percent and up to 200 percent. Keeping these loans in portfolio will tie up so much capital that banks may be unwilling or unable to originate them. This would seem to be an arbitrary risk-weight determination and not based on the actual experience community banks have had with regard to the performance of balloon payment mortgages.

Home equity lines of credit also provide a significant source of income for community banks and an important financing option for their customers. The increased risk weight will prohibit many community banks from continuing to offer this type of loan and diminish both profit opportunity and a service to their communities with no specific quantitative analysis that demonstrates increased risk to these banking institutions.

In addition to requiring a bank to hold much more capital for some mortgage products, assigning different risk weights to different LTVs and different mortgage products eliminates a bank's ability to risk-weight by asset class and instead requires the bank to risk-weight individual loans. These requirements will add significant cost and complexity to a bank's operations.

NAHB believes the proposed revisions to the risk-weights of residential mortgage loans will take too much capital out of the lending industry and have an overall negative impact on community banks and consumers.

2. Commercial Real Estate Loans

The Agencies' proposal to require all banking organizations to designate certain commercial real estate loans as HVCRE financings and assign these loans a 150 percent risk-weight will have a chilling effect on a community bank's capacity and willingness to provide financing for these commercial real estate projects. As proposed, the subset of AD&C loans that would continue to have a 100 percent risk weight (or 50 percent in the case of 1-4 family pre-sold construction loans) is quite limited. Community banks wanting to support local real estate developers and builders would find their capacity for making commercial loans outside of the tightly drawn parameters for non-HVCRE extremely restricted due to the extra capital reserves that would be required. As written earlier in this letter, construction lending is an important line of business for small community banks. NAHB believes the applicability of HVCRE to community banks will be detrimental to community banks and their support for local real estate development and construction businesses.

3. Treatment of Mortgage Servicing Assets

The Agencies' proposed treatment of Mortgage Servicing Assets (MSA) would result in dramatic changes to the value of MSAs. Traditionally, MSAs have added value to a banking organization's balance sheet. Today, 100 percent of the value of MSAs counts toward a bank's Tier 1 capital ratio. However, the proposed rules would eliminate most of this value and make it very "expensive" to hold MSAs. The Proposed Rules recommend that the value of MSAs that exceed 10 percent of a bank's common equity must be deducted from capital. Any MSAs not deducted from capital would be risk-weighted at 250 percent.

Banks that benefit currently from the important customer service relationships and cross-selling opportunities of holding mortgage servicing, in addition to an income stream, would find it considerably more capital intensive to hold MSAs and may therefore be unable to make it worthwhile from a cost-benefit perspective. NAHB believes this will eliminate essential income-producing opportunities for community banks.

4. Investments in Mortgage-Backed Securities

The Proposed Rules would create a significant disincentive for community banks to invest in private label securities (PLS). While the PLS market has not been active in recent years, it played a critical role in housing finance until the financial market crisis. A return to a robust PLS market is important to a housing recovery. However, the treatment of PLS suggested in the NPR adds complicated compliance requirements to banks that NAHB believes will hinder a recovery in the PLS market and limit the investment opportunities for community banks.

The NPR incorporates a Dodd-Frank Act requirement that banks no longer can rely on external credit ratings to make investment decisions. Banks must do their own extensive, complex and costly due diligence to determine the exact nature of the investment and the credit risks involved. Required due diligence includes an analysis of the structural features of the securitization and relevant information about the performance of the underlying mortgages, i.e., the percentage of loans 30, 60, and 90 days past due; default rates; prepayment rates; loans in foreclosure; property types; occupancy; average credit score or other measures of creditworthiness; average LTV ratio; and industry and geographic diversification data.

This analysis must be done no less than quarterly. If the banking organization is unable to demonstrate a comprehensive understanding of a securitization to the satisfaction of its primary federal supervisor, the banking organization would be required to assign a risk weight of 1,250 percent to the exposure. Investments in Fannie Mae and Freddie Mac securities will not require this due diligence and still will be assigned a 20 percent risk weight.

NAHB is concerned that the due diligence required to purchase and hold PLS will be so onerous for community banks, they will be unable to purchase PLS as investments to the detriment of both the community bank and the recovery of a PLS market.

5. Unrealized Gains and Losses on Available-for-Sale Securities

The Proposed Rules would change the calculation for determining a banking organization's regulatory capital in such a way that the use of available-for-sale (AFS) securities as hedges against interest rate risk or simply as investments will be severely restricted or eliminated. Banks will be required to recognize unrealized gains and losses on available-for-sale securities and adjust capital accordingly. Adjustments to capital based on mark-to-market valuations of these investments will create significant volatility in a bank's capital ratios. As interest rates rise, banks will be compelled to hold additional capital against assets for which there has been no indication of increased risk or impairment, only a shift in the interest rate environment. Rather than risk being "undercapitalized," banks may be cautious and hold extra capital to compensate for potential swings in interest rates. NAHB believes this would further hinder growth and lending opportunities for community banks.

If the NPR is adopted, it is certain community banks will be compelled to change how they do business. To continue conducting business as they do now will require them to hold much more capital on their books. Community banks will be forced to make choices, based largely on the impact of increased regulatory capital, between lending and not lending; holding loans in portfolio and selling loans; purchasing mortgage-backed securities as investments or not; using mortgage servicing assets as a potential income stream and customer retention tool and not having these options available; and utilizing or not the investment and risk management strategies of AFS securities.

In short, under the NPR, community banks will have to raise additional capital or decrease lending. Community banks generally find it harder to raise capital than the larger regional and national banks. It requires any or all of the following: increasing deposits; selling stock, finding investors; selling debt; or selling assets. With limited ability to raise capital, community banks may be forced to restrict the assets they put on their books, in particular those assets that are capital intensive or provide a particularly onerous compliance burden, or both.

Setting aside the expected negative implications of the Proposed Rules due to increased capital reserves and restricted lending resources, the actual act of implementing the new rules would create challenges that may prove impossible for some banks to overcome. Calculating capital based on the amended capital formula and new risk weights would be extremely complex. Incorporating new reporting, disclosure and due diligence requirements will require significant investment in technology and employee training. Some banks will have to add staff in order to meet all the new compliance responsibilities. It is impossible to know how many banks will not survive, but NAHB believes that all will experience some degree of difficulty in meeting the burden that would be imposed by the Proposed Rules.

CONCLUSION

NAHB believes the NPR would have a significantly negative impact on all the participants in the housing and housing finance industries. Financial institutions would be forced to hold additional capital, in some cases excessive capital, and home buyers/home owners, home builders, and multifamily and commercial real estate developers would suffer as a result of less available and less affordable credit.

Given the potentially negative impact of the NPR, NAHB urges the Agencies to conduct further study and empirical analysis of the proposed regulatory capital rules on the real estate markets and the economy prior to implementing a final rule. NAHB also requests that, based on the empirical studies, the Agencies re-propose the NPR with a public comment period prior to implementing a final rule.

Further, NAHB recommends that banking organizations, particularly community banks, that currently comply with the general risk-based capital rules be exempt from the Standardized Approach. It is fully within the discretion of the U.S. banking regulators, and fully consistent with the Basel framework, to continue not to apply the Standardized Approach to U.S. banking organizations.

Thank you for the opportunity to submit comments on this important NPR. If you have any questions, please feel free to contact Rebecca Froass, Director, Financial Institutions and Capital Markets, at 202-266-8529 or rfroass@nahb.org.

Sincerely,

David L. Ledford

David L. Ledford