



March 11, 2016

Mr. Stefan Ingves
Chairman
Basel Committee on Banking Supervision
Basel, Switzerland

Reference: Consultative Document – *Revisions to the Standardised Approach for Credit Risk*

Dear Mr. Ingves:

The Mortgage Bankers Association¹ (MBA) appreciates the opportunity to comment on the Basel Committee on Banking Supervision's (Basel Committee) Second Consultative Document titled *Revisions to the Standardised Approach for Credit Risk* (Second Consultative Document).² The following are MBA's general comments.

Background

For banks in the United States, the rollout of Basel III included updates to the definition of capital, updates to the Standardized Approach (including risk weights for various asset categories and off-balance sheet positions), and updates to the Advanced Approach used by the largest banks. The Basel Committee rolled out its definition of capital several years ago and did not update risk weights under the Standardized Approach at that time. The Basel Committee's First Consultative Document was issued in December of 2014 for determining the appropriate risk weight regime for credit exposures for those using the standardized approach.

The Basel Committee considered the responses from that First Consultative Document and issued the Second Consultative Document in December 2015. MBA commends

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.mba.org.

² Basel Committee on Bank Supervision, Second Consultative Document, Standards, Revisions to the Standardized Approach for Credit Risk, December 2015.

the Basel Committee for reflecting in the Second Consultative Document much of the constructive input made to the prior proposal. While MBA recognizes this significant progress, we will address the areas of the Second Consultative Document that would benefit from greater clarification or modification. This letter supplements MBA's prior submittal.³

General Comments

Proposed Treatment of Single Family Mortgage Loans

Final U.S. Rule

The final U.S. rule under Basel III retained the 50 or 100 percent risk weights to exposures secured by one-to-four family residential properties (residential mortgage exposures). Under the U.S. rule, residential mortgage exposures that are "prudently underwritten and that are performing according to their original terms⁴" receive a 50 percent risk weight, while all other residential mortgage loans, including junior liens, are assigned a 100 percent risk weight. A residential mortgage loan guaranteed by the federal government through the Federal Housing Administration (FHA) or the Department of Veterans Affairs (VA) will have a risk weight of 20 percent⁵. U.S. regulators considered and rejected a proposed approach in their Notice of Proposed Rulemaking (NPR) that would have included a framework for risk-weighting residential mortgages based on underwriting and product features, including loan-to-value ratios (LTV). Instead they decided to stick with the definition (prudently underwritten and performing) that was written as part of Basel I. MBA agrees with the U.S. Basel III risk-weighting of residential mortgages and believes that the Basel Commission should consider this more "principles-based" approach in coming up with its final standard especially since the standard would apply to a variety of sovereign jurisdictions each with different mortgage banking laws, rules, and regulations and commercial customs.

Basel Commission's Last Proposed Risk Weights for Residential Mortgages

The Basel Commission's First Consultative Document proposed to abandon the existing 35 percent risk weight and replace it with a regime that risk weights residential mortgages based upon two underwriting factors:

- LTV
- Debt Service Coverage Ratio (DSC)

The DSC was defined in a similar manner to the "back-end debt to income ratio" (DTI) in the United States, with one major difference. The DSC would be calculated using net income **after taxes**.

³ MBA Consultative Document – *Revisions to the Standardised Approach for Credit Risk*, March 25, 2015.

⁴ OCC, Fed and FDIC, Basel III Final Rule, page 40.

⁵ Ibid, page 259.

The ultimate risk weight for a loan would be determined using a look-up table with the LTV and DSC as the driving factors placing risk weights from 25 percent to 100 percent. The First Consultative Document appears to give no credit for loans having a federal guarantee like FHA and VA loans. Further, it appears to ignore the favorable impact private mortgage insurance coverage has on reducing loss severity in the event of default.

MBA Objects to the Use of LTV

The revised proposal takes out the DSC and goes with a look-up table based on LTV only.

The risk weight table for residential real estate exposures:

Table 9 (Repayment is not materially dependent on cash flows generated by property)

LTV $\leq$ 40%	25% risk weight
40% < LTV $\leq$ 60%	30%
60% < LTV $\leq$ 80%	35%
80% < LTV $\leq$ 90%	45%
90% < LTV $\leq$ 100%	55%
LTV > 100%	Risk weight of counterparty

For investment property loans where repayment is highly dependent on cash flows generated by the property, Table 10 would establish the following risk weights: LTV < or = 60%, risk weight 70%; LTV > 60% but < or = 80%, risk weight is 90%; LTV > 80%, risk weight is 120%.

MBA notes that the proposed approach is much improved from the approach outlined in the First Consultative Document. In its comment letter dated March 25, 2015, MBA stated “the housing and mortgage markets and infrastructure are so different when comparing various Basel nations that the rules-based approach using two underwriting characteristics will be flawed. Rather, MBA proposes that the Basel Commission adopt a more principles-based standard similar to the one used successfully for decades in the United States. Well-underwritten loans that are performing should be the standard. That standard is broad enough to take into account loan-to-value, debt-to-income, credit score, level of documentation, characteristics of the loan itself, and other important aspects to the credit strength.”

MBA still believes this to be the case with respect to the use of a proposed table based upon LTV.

The Risk Weight Should Take Into Account Loan Seasoning

The Second Consultative Document uses LTV, and does not allow updates after a loan seasons for several years. MBA notes that defaults generally occur in the early years of

a mortgage, and loans that have seasoned without delinquency should be granted lower risk weights. If the Basel Committee moves forward with the regime for mortgages in its Consultative Document, it should allow for periodic updating of the LTV.

Government Insured Loans and Loans with MI Coverage

The final rule should allow reduced risk weights for loans insured or guaranteed by the government or by private mortgage insurers, assuming the government or insurer is deemed creditworthy under the new rules.

Under the Second Consultative Document, the risk weight of a particular mortgage is entirely dependent upon the LTV calculation. However, the Second Consultative Document does not expressly recognize loan level mortgage insurance (MI) from this calculation.

When backed by a strong counterparty, MI significantly reduces loss severity.⁶ The primary effect of the Second Consultative Document's exclusion of MI from LTV calculations will be to shift additional costs onto prospective home buyers.

Finally, the Second Consultative Document will result in much higher pricing to consumers or will significantly delay the time it would take to save for a down payment, especially for first time home buyers who do not have significant equity to invest in their respective homes.

Borrower's Ability to Repay

In order to apply the risk weights in Table 9 and 10 above, the lender must underwrite the loan in a manner that would demonstrate the "ability of the borrower to repay." MBA believes that this would also be encompassed in a principles-based standard based upon "properly underwritten loan."

Proposed Treatment of Commercial Real Estate Loans

Revisions to the First Consultative Document for Commercial Real Estate Loans that are Structured as Special Purpose Entities

An area of concern raised in MBA's March 25, 2015 letter was the punitive capital treatment of commercial real estate loans for projects organized as Special Purpose Entities (SPEs). These loans receive a risk weight of at least 120 percent,⁷ which is significantly higher than the existing 100 percent risk weight for commercial real estate

⁶ See, e.g., *Global Criteria for Lenders' Mortgage Insurance in RMBS*, Fitch Ratings, August 3, 2012 and Lauri Goodman and Jun Zhu, Urban Institute, *Loss Severity on Residential Mortgages*, February 2015, page 1..

⁷ The greater of the counterparty risk weight or 120 percent.

loans in the U.S. In the prior proposal, SPEs were included in the “specialised lending” category, which required the 120 percent or greater risk weight.

In the specialised lending section of the Second Consultative Document, a new provision was added that moved all real estate lending activity, including commercial real estate projects that are organized as SPEs, into the “real estate exposure class”. As such, commercial real estate projects that were organized as SPEs no longer automatically fall into the 120 percent risk weight category due to their SPE status. MBA strongly supports this change because the SPE structure does not elevate the risk for a commercial real estate loan.

Revisions to the Second Consultative Document for Commercial Real Estate Loans

The Second Consultative Document divides commercial real estate exposures into two categories: (1) Repayment is not materially dependent on cash flows generated from the property; and (2) Repayment is materially dependent on cash flows generated by the property. The first category is generally associated with owner occupied buildings while the second category is primarily comprised of commercial real estate that generates rental income for its owners.

The First Consultative Document requested comments regarding two options for determining the risk weights for commercial real estate loans: (1) risk weight of the counterparty; or (2) the loan to value ratio. In the March 25, 2015 letter, MBA strongly opposed using the counterparty’s risk weight for solely determining the risk weight for all commercial real estate loans because, among other things, this approach failed to take into consideration the underwriting parameters for commercial real estate loans.

The Second Consultative Document refines this approach by providing separate methodologies for determining the risk weights for owner occupied and income producing commercial real estate. MBA believes that such an approach represents a better approximation of the underlying risk of a commercial real estate loan and is shown below:

Table 1 Risk weight table for commercial real estate exposures ⁸ (Repayment is not materially dependent on cash flows generated from the property)		
	LTV Less than or equal to 60%	LTV > 60%
Risk Weight	Min (60%, RW of Counterparty)	RW Counterparty ⁹

⁸ Second Consultative Document, p 37.

⁹See Second Consultative Document, page 37, “For commercial real estate loans to individuals with an LTV ratio higher than 100%, the risk weight applied will be 75%. For commercial real estate loans to SMEs (as defined in paragraph [45]) with an LTV ratio higher than 100%, the risk weight applied will be 85%”.

Table 2 Risk weight table for commercial real estate exposures ¹⁰ (Repayment is materially dependent on cash flows generated by the property)			
	LTV Less than or equal to 60%	LTV Between 60% and 80%	LTV > 80%
Risk Weight	80%	100%	130%

Regarding both categories, MBA recommends that the prudential regulators from each country carefully examine and adjust accordingly the risk weights based upon the performance of commercial real estate loans in their country. At a minimum, MBA recommends that the 130 percent risk weight for income producing properties with a LTV greater than 80 percent (Table 2) be reduced to 120 percent to reflect the risk weight of residential real estate exposures that are materially dependent on such flows generated by the property.¹¹

Regarding Table 1, MBA recommends that for loans with LTV's of greater than 60 percent, the risk weight should be capped at no higher than the risk weight for loans with a greater than 80 percent LTV in Table 1. This recommendation reflects that during times of distress, the lending institution can liquidate the commercial real estate property to recover the outstanding loan balance. Given this ability, we do not believe that owner occupied properties (Table 1) should receive a higher risk weight than the highest risk weight category for income producing properties (Table 2).

Qualifying Criteria for Risk Retention Treatment Specified in Tables 1 and 2

In order for commercial real estate loans to qualify for favorable risk weight treatment, they must meet requirements specified in the Second Consultative Document for the following loan characteristic categories:¹²

- Finished property
- Legal enforceability
- Claims over the property
- Ability of the borrower to repay
- Prudent value of property
- Required document

If a commercial real estate loan does not meet all requirements specified in these categories, they will be required to have a higher risk weight, which are severe. For income producing commercial real estate (Table 2) this risk weight increases to 150 percent and for owner occupied commercial real estate (Table 1) the risk weight is the higher of 100 percent or the risk weight of the counterparty.¹³ Consequently, meeting

¹⁰ Second Consultative Document, p 37.

¹¹ Second Consultative Document, p. 36.

¹² Second Consultative Document, p. 34.

¹³ Second Consultative Document, p. 37.

the preceding loan requirements is essential to receiving the more favorable risk weights specified in the tables.

We are concerned that requirements for a prudent commercial real estate property valuation will need to be modified to account for existing commercial real estate appraisal practices and mandated professional practices. Shown below is the appraisal requirement that raises concern:

To ensure that the value of the property is appraised in a prudently conservative manner, this value must exclude expectations on price increases and must be adjusted to take into account the potential for the current market price to be significantly above the value that would be sustainable over the life of the loan.¹⁴

We are concerned that application of such guidance would limit the ability of an appraiser to accurately assess the value of the commercial real estate project. Commercial real estate values fluctuate due to the commercial real estate market cycle. When a project is appraised at the bottom of a market cycle, it is reasonable to expect values to increase over time as they have in every U.S. commercial real estate cycle. Additionally, the assumption that current market price cannot be sustained over the life of the loan depends on the duration of the loan and the timing within the real estate cycle the commercial real estate loan was made.

The *Uniform Standards of Professional Appraisal Practice* (USPAP) is the generally recognized ethical and performance standards for the appraisal profession in the United States. USPAP was adopted by Congress in 1989, and contains standards for all types of appraisal services, including real estate, personal property, business and mass appraisal. Compliance is required for state-licensed and state-certified appraisers involved in federally-related real estate transactions.¹⁵ MBA believes that matters involving appraisal methodology should be left to the professional standards and practices required in each country. As such, the appraisal methodology considerations specified in the Second Consultative Document should be withdrawn in order to avoid any potential conflict with country-specific mandated appraisal standards and practices.

Because appraisal standards can vary by country, value determinations for commercial real estate should be based upon each country's appraisal standard. Given that the loan-to-value ratio is used for assigning the risk weight for commercial real estate loans, the loan-to-value ratio could potentially be distorted if the appraisal methodology did not conform to country-specific appraisal standards. MBA notes that the loan-to-value ratio indicates how much equity the borrower has in the commercial real estate project. An indicator of the ability for the borrower to repay the commercial real estate loan is reflected in the debt-service coverage ratio and should be a consideration in the "Ability of the borrower to repay" category.

¹⁴ Second Consultative Document, p. 35.

¹⁵ USPAP description from the following link:

http://www.appraisalfoundation.org/imis/TAF/Standards/Appraisal_Standards/TAF/USPAP.aspx?hkey=5a640dda-464d-4683-b4e1-190201e0eda7

Prudential regulators should carefully review and revise the six qualifying criteria for the lower risk weight treatment (Tables 1 and 2) in order to conform this criteria with country-specific prudent and customary commercial real estate lending practices. In doing so, unnecessary and inadvertent disqualification from the lower risk weight treatment can be avoided for prudentially underwritten commercial real estate loans. MBA underscores this recommendation for the “Ability of the borrower to repay” category because underwriting practices for commercial real estate loans can vary significantly from country to country.

Acquisition, Development and Construction Lending

The Second Consultative Document specifies a 150 percent risk weight for acquisition, development and construction (ADC) loans.¹⁶ Under Basel III, as adopted in the United States, ADC loans that meet certain underwriting criteria are treated like commercial real estate loans and carry a risk weight of 100 percent. The underwriting criteria includes but is not limited to: (1) loan-to-value ratio of no more than 80 percent and (2) 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. ADC loans not meeting these criteria are deemed to be High Volatility Commercial Real Estate Exposure (HVCRE) and are subject to a 150 percent risk weight.

We are concerned that the 150 percent risk weight treatment for all ADC loans is overly prescriptive and fails to take into consideration the varying risk profiles of ADC loans. The U.S. risk weight approach allows the risk profile of an ADC loan to be assessed and appropriately categorized for risk weight purposes. For example, ADC loans with LTVs of less than 80 percent and cash or readily marketable assets of at least 15 percent of the “as completed” value provide for sufficient counterparty “skin in the game” and a liquid asset cushion in the event of overruns or unforeseen contingencies. Accordingly, they receive the lower 100 percent risk weight. MBA urges the Basel Committee to withdraw its one size fits all risk weight approach for ADC loans and allow each country to set their own requirements for ADC loans that would qualify for a 100 percent risk weight.

¹⁶ Second Consultative Document, page 37.

Conclusion

MBA appreciates the opportunity to share its observations 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 jgross@mba.org or George Green, Associate Vice President, Commercial/Multifamily Group, at ggreen@mba.org.

Sincerely,

A handwritten signature in black ink, appearing to read "D.H. Stevens", with a stylized flourish at the end.

David H. Stevens, CMB
President and Chief Executive Officer
Mortgage Bankers Association