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SUBJECT: Comments on the Real Estate Provisions of the New Basel Capital Accord

Ladies and Gentlemen:

The Mortgage Bankers Association of America (MBA) welcomes the opportunity to comment on the draft New Basel Capital Accord (Basel II) issued on April 29, 2003. We commend the Basel Committee for its efforts to promote the safety and soundness of real estate investments. Sound financial investments boost investor confidence and encourage prudent capital flow. Because MBA actively encourages both market liquidity and judicious underwriting practices, our comments will focus on recommendations to reconcile Basel II's framework and the specific risk weights proposed for various categories of loans with the need to meet real estate industry liquidity and underwriting goals, recognizing that inappropriate weights could adversely affect investment in communities and economic vitality, both in the United States and elsewhere.

Background on MBA and the U.S. Real Estate Finance Industry. MBA is the national association representing the U.S. real estate finance industry. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's real estate markets; to expand homeownership prospects through increased affordability; and to extend access to affordable housing to all Americans. MBA's membership of 2,600 companies includes all elements of residential real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, and others in the home mortgage lending field.

MBA is also the leading representative of America's $1.8 trillion commercial real estate finance industry. MBA's constituency includes the commercial banks and thrift institutions which represent the single largest source of capital for U.S. commercial real estate, as well as the issuers, servicers, bondholders and administrators of commercial mortgage-backed securities

(CMBS), who provide secondary market liquidity to America's commercial real estate sector. MBA and its members are committed to the vibrancy of U.S. commercial real estate finance industry and wish to see the final Basel II guidelines support the health of this sector.

The savings of most Americans are invested in deposit accounts at American banks, including commercial banks and thrift institutions. In addition, life insurance companies and pension funds are key investors in the $332 billion CMBS market, which is backed by commercial real estate loans. Therefore, the financial security of average Americans, including small depositors, the policyholders of life insurance companies, pensioners and other small investors, is broadly affected by the security and liquidity of the real estate debt market. MBA is committed to representing these consumers by promoting the safety and vitality of real estate lending, on both the commercial and residential fronts.

Because MBA believes that the proposed Basel II structure and risk weights are more problematic for the commercial real estate sector than for the single-family sector, our comments focus primarily on the former.

Risk Weights in Assigned Categories. MBA supports the use of international guidelines that can be flexibly interpreted by national banking authorities. MBA believes that the risk rating system proposed under the April 29, 2003 draft of Basel II, assigns excessive risk weights to certain loan categories based on historic performance data. In this context, MBA observes that the capital set-aside requirement for life insurance companies with respect to commercial real estate loans in good standing is considerably below the 4%-6% standard established for the highest quality commercial real estate loans under the proposed Basel II framework. Life insurance companies and commercial banks compete for mortgage transactions. The heavier set-aside requirements for commercial real estate lending proposed under Basel II may therefore erode the competitive position of commercial banks relative to life insurance companies in the commercial real estate finance realm.

MBA also notes the following:

- Land acquisition, construction and development loans for single-family housing are included in the high volatility commercial real estate (HVCRE) category (in which "Good" to "Satisfactory" loans carry risk weights of 125% to 175%), despite the fact that the historical default rates on such loans are well-below commercial real estate averages and are more similar to those associated with mortgages for owner-occupied one- to four-family housing (to which the April 29, 2003 draft standards assign a 35% risk weight). Similar evidence is presented in a June 2003 white paper authored by the U.S. Board of Governors of the Federal Reserve System, which notes that asset default correlations for single-family land acquisition and construction loans are substantially below those for other types of commercial properties. MBA therefore recommends that one- to four-family land acquisition, construction and development loans be moved to the income-producing real estate (IPRE) category, which uses slightly lower risk weights (100% to 150% for "Good" to "Satisfactory" loans).

- As proposed in the April 2003 draft Accord, MBA concurs that national banking authorities should be permitted to reclassify land acquisition, construction and development loans that are significantly pre-sold or pre-leased to tenants with satisfactory credit profiles from the HVCRE category to the IPRE category.

- It is unclear whether Basel II considers the customary practice of employing credit enhancements to bolster the credit quality of commercial real estate loans when assigning risk weights. MBA requests that banking regulators be permitted to consider credit enhancement vehicles that have proven to be effective in decreasing risk when assigning risk weights.

Incentives for Lenders who Adopt Exemplary Underwriting Standards, Practices and Technologies. The final Accord should offer concrete incentives for real estate lenders to adopt high-quality underwriting practices and technologies. To this end, MBA recommends that the final Accord establish preferential risk weights—or permit national banking authorities to do so—for all commercial loans rated “Good” or better which utilize exemplary underwriting standards, practices and technologies. Precedent for this approach is found in the American mortgage-backed securities industry, in which the practices, procedures and technologies used by loan servicing firms are evaluated when ratings are assigned.

MBA believes that the introduction of preferential capital standards for the use of exemplary underwriting standards, practices and technologies would encourage banking entities across the globe to carefully underwrite, value and monitor their commercial real estate credits. The introduction of such incentives would also be beneficial to commercial real estate lenders who cannot qualify for the advanced internal ratings based approach available to the largest lenders under Basel II, but who nevertheless exemplify excellence in the use of state-of-the-art underwriting standards, practices and techniques.

There is considerable evidence to suggest that the use of enhanced underwriting standards, practices and technologies materially reduces commercial real estate loan default rates:

- The July 2003 Standard and Poor’s study documents declines in U.S. commercial real estate loan default rates that parallel a period of improvement in U.S. underwriting practices and technologies, including the adoption of more stringent appraisal standards, the growing use of underwriting standards established by the secondary market rating agencies, and the introduction of lease-based valuation software.

- The U.S. Board of Governors of the Federal Reserve, in a June 2003 White Paper, also has reported time-series data showing declines in asset default correlations for commercial real estate loans since the mid-1990s, both in absolute terms and relative to commercial and industrial credits. Industry participants suggest that these declines mirror improvements in underwriting practices and technology that have accompanied the growth of secondary market securitization, the adoption of more stringent appraisal and valuation standards, and the introduction of lease-based valuation software. These developments appear to have improved market transparency and the sophistication of underwriting models, with the effect of reducing commercial real estate credit risk.

MBA and its member financial institutions look forward to working with the Basel Committee, BIS, U.S. banking regulators, and other interested parties on the development and implementation of the Basel II standards for real estate lending. To ensure the safety and soundness of our financial institutions, MBA recommends that Basel II reflect the underlying risk of loans secured by single-family and commercial real estate through refined risk weights and reward lending institutions that utilize exemplary underwriting standards, practices and technologies.

Please do not hesitate to contact MBA if we may be of further assistance. Should you have any additional questions, please contact Leanne Tobias, Director, Commercial Real Estate Finance (tel: 202/557-2840; e-mail: leanne_tobias@mbaa.org).

Most sincerely,

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