NATIONAL ASSOCIATION OF HOME BUILDERS

July 30, 2003

Basel Committee Secretariat
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002
Basel, Switzerland

Dear Basel Committee Secretariat:

On behalf of the 211,000 member firms of the National Association of Home Builders (NAHB), I welcome the opportunity to respond to the Basel Committee on Banking Supervision's request for comments on the third consultative paper (CP3) on the new Basel Capital Accord (Basel II). NAHB is a national trade association representing individuals and companies involved in the production of housing and related activities. NAHB and its members are committed to ensuring that all consumers have access to the housing of their choice. Each year, NAHB's builder members construct about 80 percent of all new housing in America.

The Basel Committee's goal to improve the capital adequacy framework for large, financially active institutions is ambitious, and NAHB appreciates the committee's efforts to promote sound risk assessment and management capabilities. However, NAHB notes that while some aspects of Basel II may represent an improvement over current capital regulations, revisions to the Basel Capital Accord could unnecessarily impact the cost and availability of housing-related loans from insured depository institutions. Some of the changes reflected in CP3 could also adversely affect the competitive environment for smaller banking institutions.

Treatment of Residential Acquisition, Development and Construction Loans

Under the current regulations for U.S. financial institutions, most residential land acquisition, development and construction (AD&C) loans require a capital backing of 8 percent. This is the standard requirement for most loans and investments on U.S. financial institution balance sheets. One notable exception is the capital treatment of construction loans on pre-sold single family homes, which currently have a 4 percent capital requirement, giving these loans the same preferred capital standing as home mortgages.

Basel II's treatment of residential AD&C loans is not clearly defined in CP3. In the U.S., banking regulators are proposing that large, internationally active banking organizations be required to use Basel II's Advanced Internal Ratings-Based (A-IRB) approach for determining capital requirements for credit risk exposure. Generally, financial institutions using the A-IRB approach would assign assets and off-balance-sheet exposures into one of three credit exposure portfolios: Wholesale, Retail and Equities. The three credit exposure portfolios are subdivided into a series of risk classes, which are further striated into risk subcategories.

NAHB's concerns primarily address the Wholesale portfolio risk class identified in CP3 as Corporate Exposures. CP3 groups both residential and commercial AD&C loans into the Commercial Real Estate (CRE) subcategory of the Corporate Exposures risk class, without considering the types and risk profiles of the loans. Within the CRE risk class subcategory, loans would be further classified as either low-volatility (IPRE) or high-volatility (HVCRE) assets.

Under the A-IRB approach, an institution's internal assessment of key risk drivers for a particular exposure would serve as the primary inputs in the calculation of the institution's minimum risk-based capital requirements. Formulas, or risk weight functions, specified by supervisors would use the banking organization's estimated inputs to derive a specific dollar amount capital requirement for each exposure. Although the actual dollar amount capital requirement for each exposure has not been determined yet, it appears that the capital requirement would definitely increase for pre-sold single-family construction loans and the capital burden for all types of AD&C loans has the potential of reaching multiples of current requirements.

NAHB Position

NAHB believes that CP3 fails to make the appropriate distinctions for the highly varied credit risk characteristics of the wide range of assets assigned to the CRE risk class. Moreover, NAHB believes that the Basel Committee has mischaracterized the risks associated with residential AD&C lending activities. The consequence is that Basel II would raise the amount of capital that financial institutions must hold for many residential AD&C loans above current requirements as well as increase capital requirements for all AD&C loans relative to other assets in bank and thrift balance sheets. This treatment could discourage banks from engaging in AD&C lending activities because such lending carries the same capital expense as other riskier lending activities. This likely would result in a significant step backward from the current system, where single family construction loans on pre-sold homes receive the same preferable capital treatment accorded home mortgages, 4 percent, while other housing production loans receive the standard 8 percent capital treatment.

Analysis of time-series data from the United States Office of Thrift Supervision's (OTS) Thrift Financial Report show that the increased capital requirements that would result from Basel II are unwarranted because the charge-off rates for residential housing production loans are dramatically lower than for nonresidential real estate loans. In fact, the performance of single family home construction loans has been very close to the experience for home mortgages. We have attached a series of charts and a table with the underlying data that demonstrate the performance of residential AD&C loans compared to other asset categories.

Alternative Approach

The U.S. Board of Governors of the Federal Reserve System (Board) recently published a white paper analyzing the loss characteristics of commercial real estate loan portfolios of U.S. financial institutions. The white paper notes that some key features of single family construction loans (i.e., high proportion of pre-sales and relatively short (12-18 month) maturities) could be positive factors resulting in lower capital requirements for such loans "at national discretion." Further, the Board's analysis of available evidence suggests that the asset correlation for single-family construction loans may be smaller than the asset correlation for other construction loans. Accordingly, the Board's inclination is that single family loans should be classified as having low (IPRE) rather than high (HVCRE) asset correlation. Such a classification would confer preferred capital treatment. This treatment is also contemplated in the interagency Advanced Notice of Proposed Rulemaking approved by the U.S. financial institution regulators on July 11, 2003.

NAHB supports the Board's recommendations and urges the Basel Committee to incorporate it into the subsequent version of Basel II.

NAHB also notes that CP3 provides discretion for bank regulators to assign preferential risk weights to a "strong" or "good" loan having either (1) a remaining maturity of less than 2.5 years or (2) underwriting criteria and other characteristics suggesting that the loan is substantially stronger than other loans in its supervisory rating grade. NAHB suggests that one characteristic of the strength of an AD&C loan is whether the AD&C loan relates to property that already has a committed end-buyer (i.e. pre-sold property). In these situations, the source of repayment for the AD&C loan is likely to be well-identified, thereby mitigating the risk of default.

Competitive Impact of Basel II

NAHB is also concerned about the potential adverse effect of Basel II on the competitive position of smaller financial institutions. Small banks will be exempted from Basel II under the implementation plan proposed by U.S. financial institution regulators. Moreover, due to the daunting level of resources necessary to develop and implement a Basel II-compliant risk management system, smaller financial institutions are unlikely to opt in to Basel II. As a result, smaller institutions could find themselves at a competitive disadvantage to larger institutions whose capital costs will likely be reduced under Basel II. This situation raises serious concerns about the long-term viability of smaller community banks and thrifts. These institutions are an integral component to the infrastructure of communities throughout the U.S., and they are a critical source of funding for consumers and commercial enterprises alike. The majority of NAHB's builder members are small businesses that obtain financing from community banks and thrifts. In fact, community-based financial institutions account for the bulk of residential AD&C

lending. We urge the Basel Committee to consider the consequences that would result if Basel II were implemented without rectifying the fundamental bias against smaller financial institutions.

Conclusion

NAHB requests that the Basel Committee reconsider their proposed treatment of residential real estate loans in Basel II. Specifically, NAHB recommends that the Basel Committee adopt the approach being contemplated by U.S. financial institution regulators to establish greater risk-sensitive detail within the Commercial Real Estate (CRE) sub-category. In this regard, NAHB urges that residential construction loans be reclassified as low-volatility assets. Moreover, we request that due consideration be given to factors that could be used to assign preferential risk weights to such loans (i.e. high proportion of pre-sales and maturities of less than 2.5 years).

NAHB stands ready to work with the Basel Committee on Banking Supervision and the federal financial institution regulatory agencies to explore the various options that may be available to assign the appropriate Basel Capital Accord risk weight to residential AD&C loans. Thank you for your consideration and we invite you to call on us if we can provide additional information.

Sincerely,

Gerald M. Howard
Executive Vice President and
Chief Executive Officer

GMH/mc

Attachment

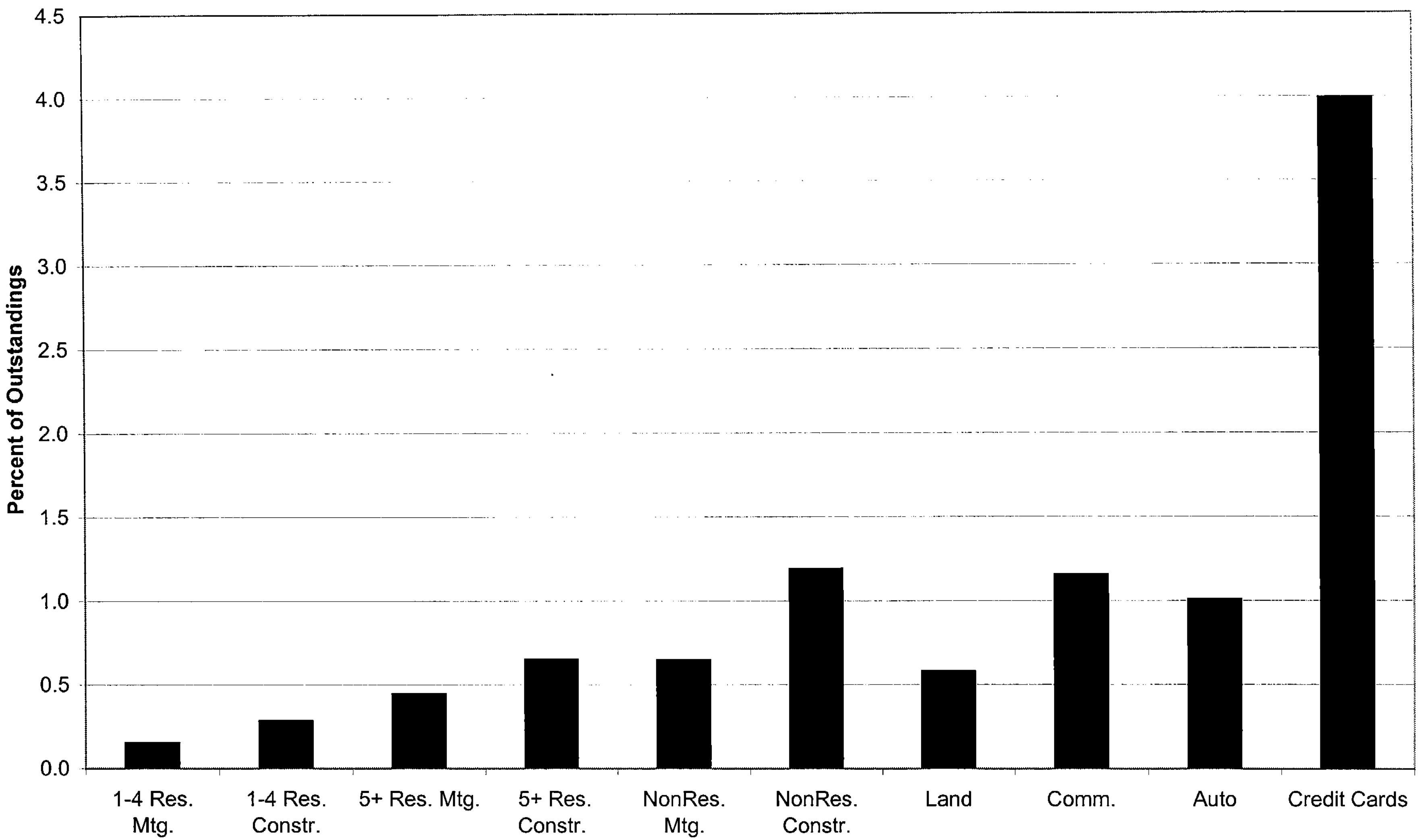
Acquisition, Development and Construction (AD&C) Loan Performance Data

Compiled by:
Housing & Finance Policy Area
National Association of Home Builders

NAHB
NATIONAL ASSOCIATION OF HOME BUILDERS

Comparison of Net Chargeoff Rates by Loan Type for All OTS Thrifts

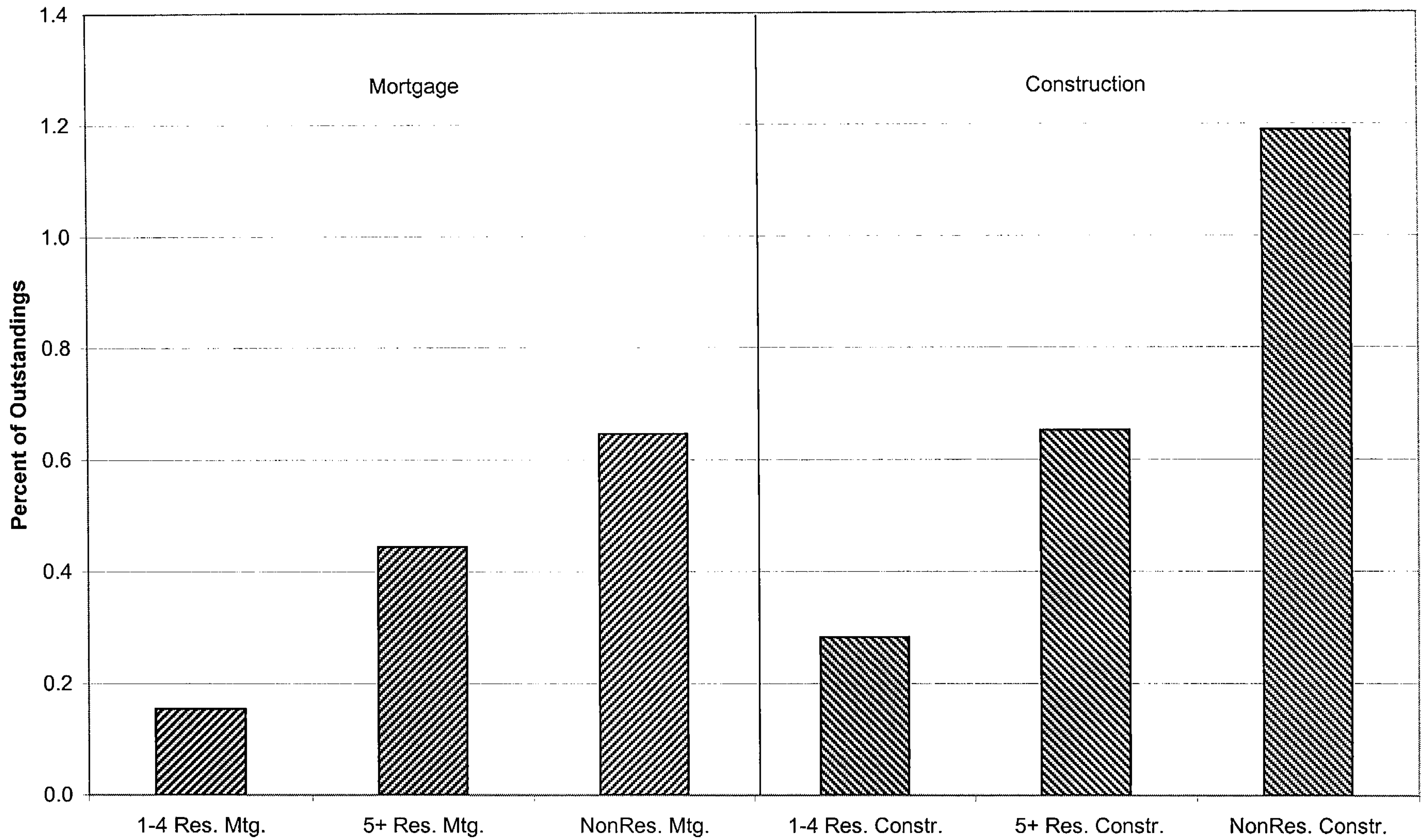
Annual Averages, 1990-2002



Savings and Loan Net Chargeoffs as Percent of Average Outstanding Loans
Source: Office of Thrift Supervision, Compiled by NAHB

Comparison of Mortgage and Construction Loan Net Chargeoff Rates

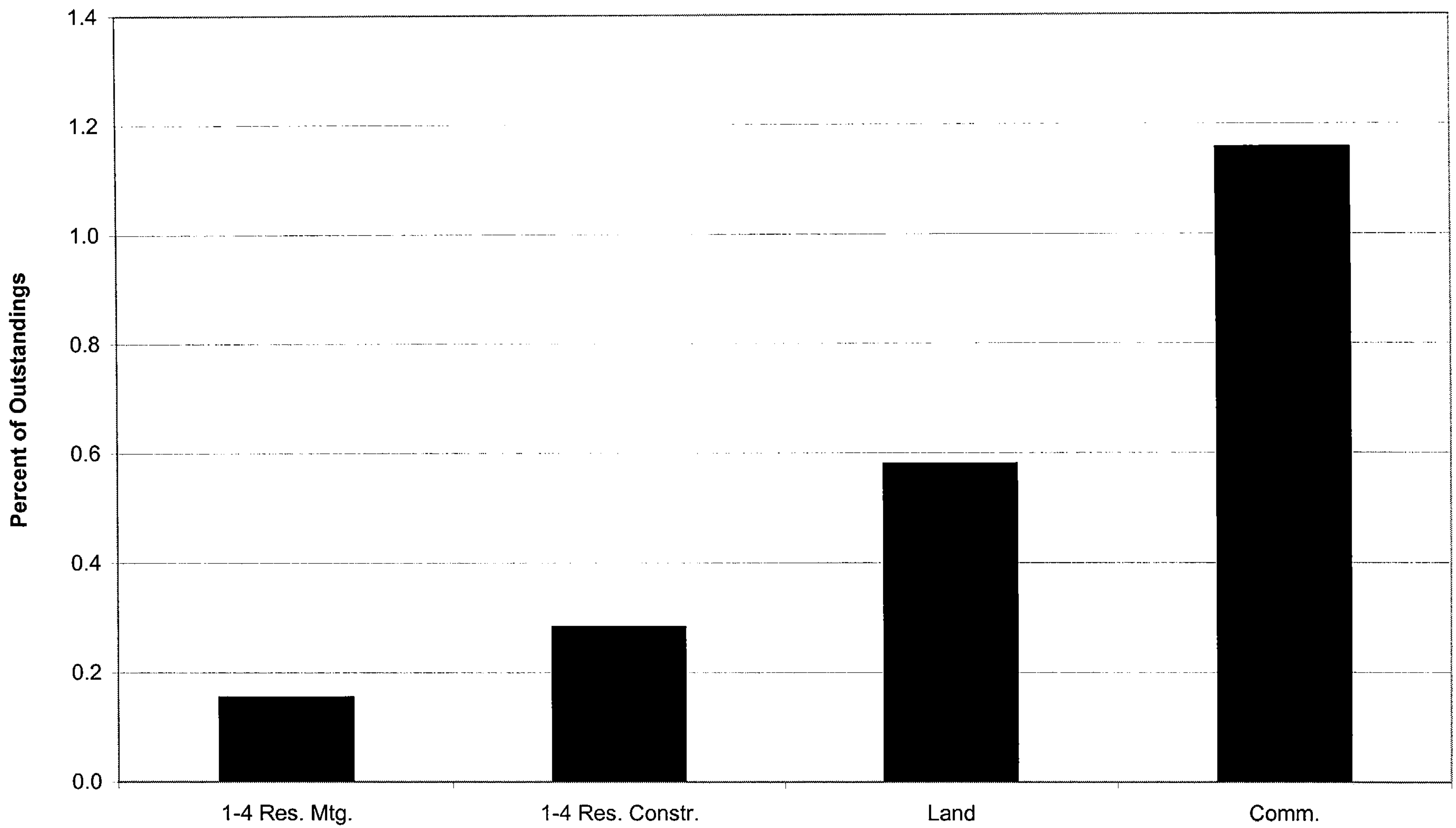
Annual Averages, 1990-2002



Savings and Loan Net Chargeoffs as Percent of Average Outstanding Loans
Source: Office of Thrift Supervision, Compiled by NAHB

Home Mortgage and Construction Loan Performance Compared to Land and Commercial Loans

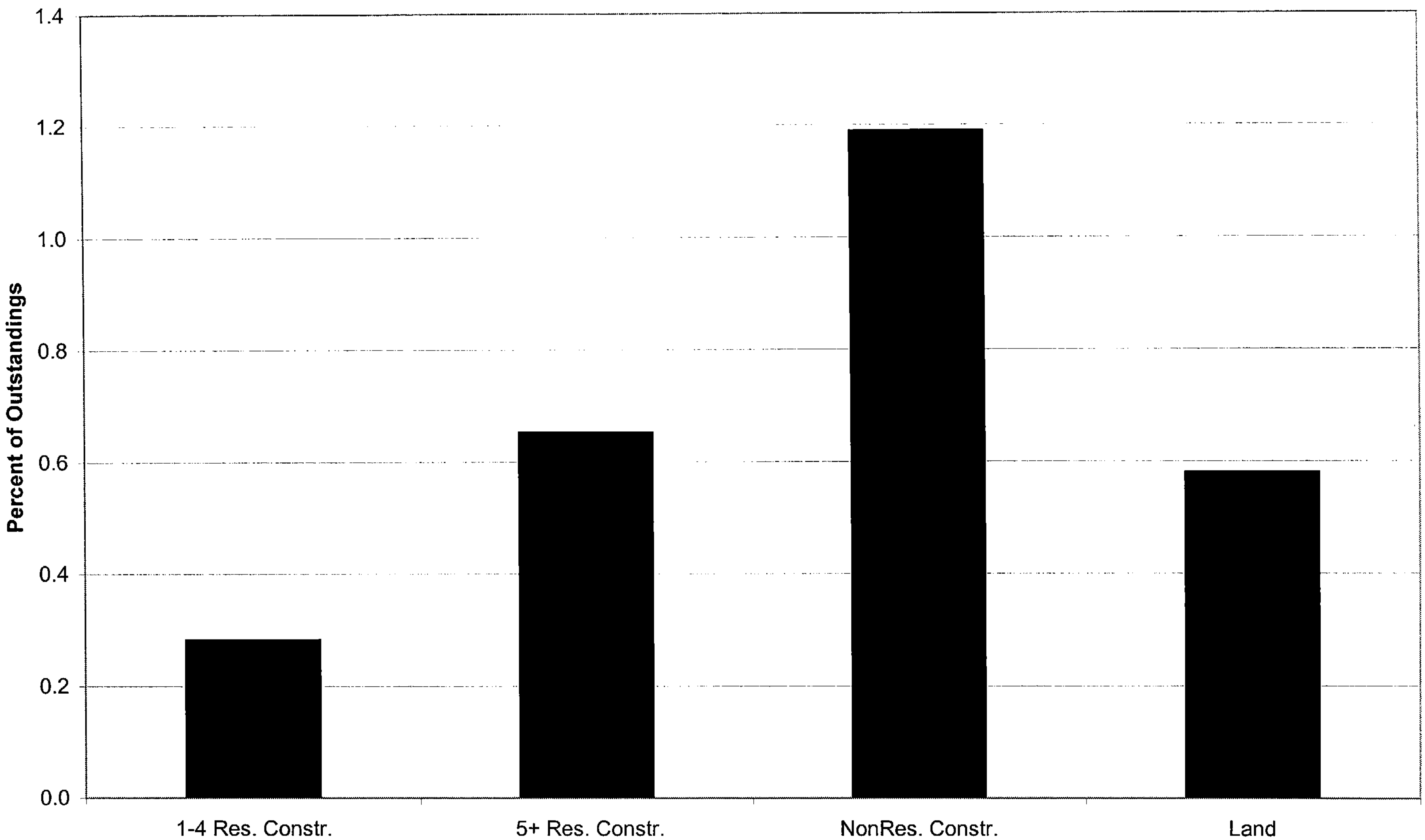
Annual Averages, 1990-2002



Savings and Loan Net Chargeoffs as Percent of Average Outstanding Loans
Source: Office of Thrift Supervision, Compiled by NAHB

Comparison of Construction and Land Loan Net Chargeoff Rates

Annual Averages, 1990-2002

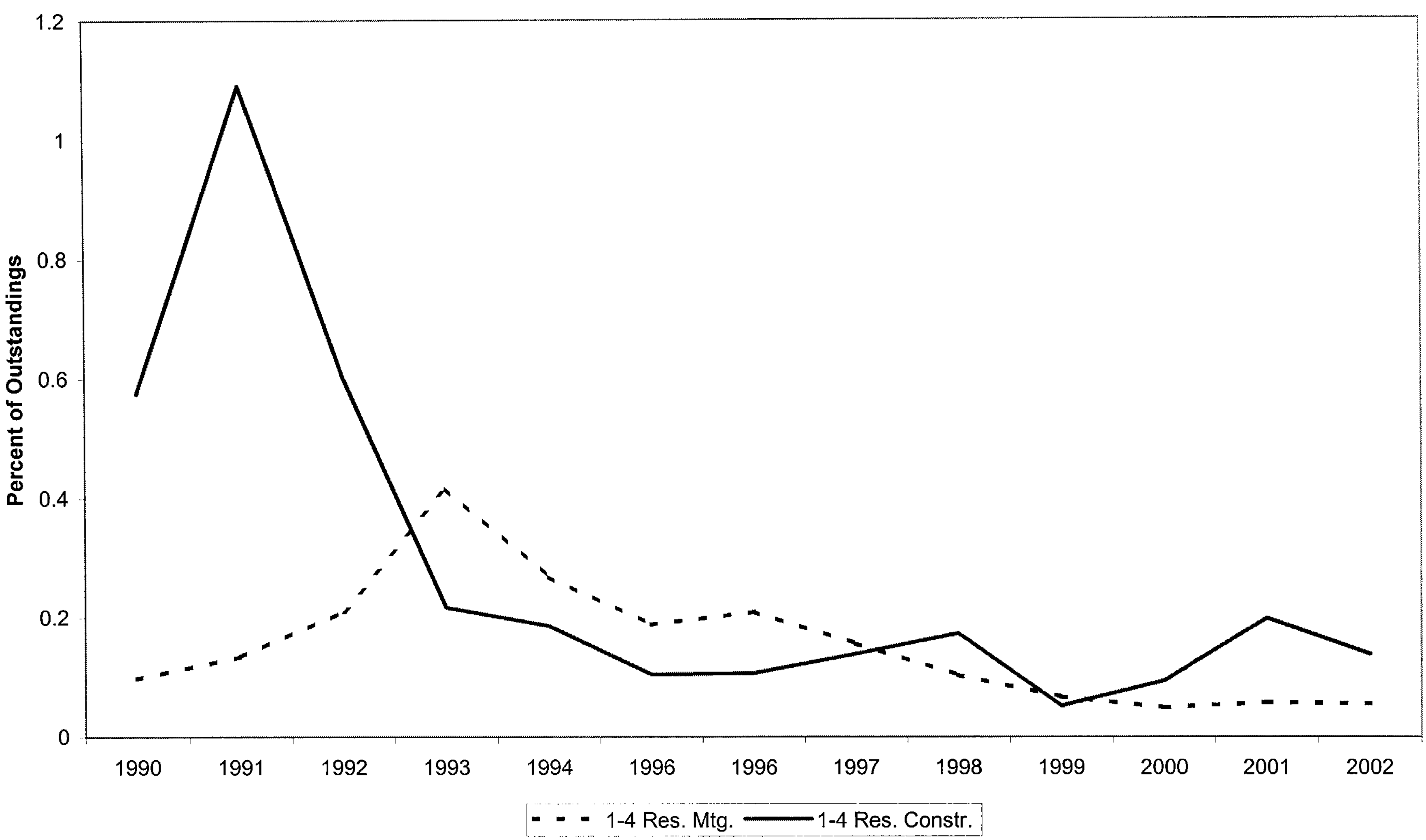


Savings and Loan Net Chargeoffs as Percent of Average Outstanding Loans
Source: Office of Thrift Supervision, Compiled by NAHB

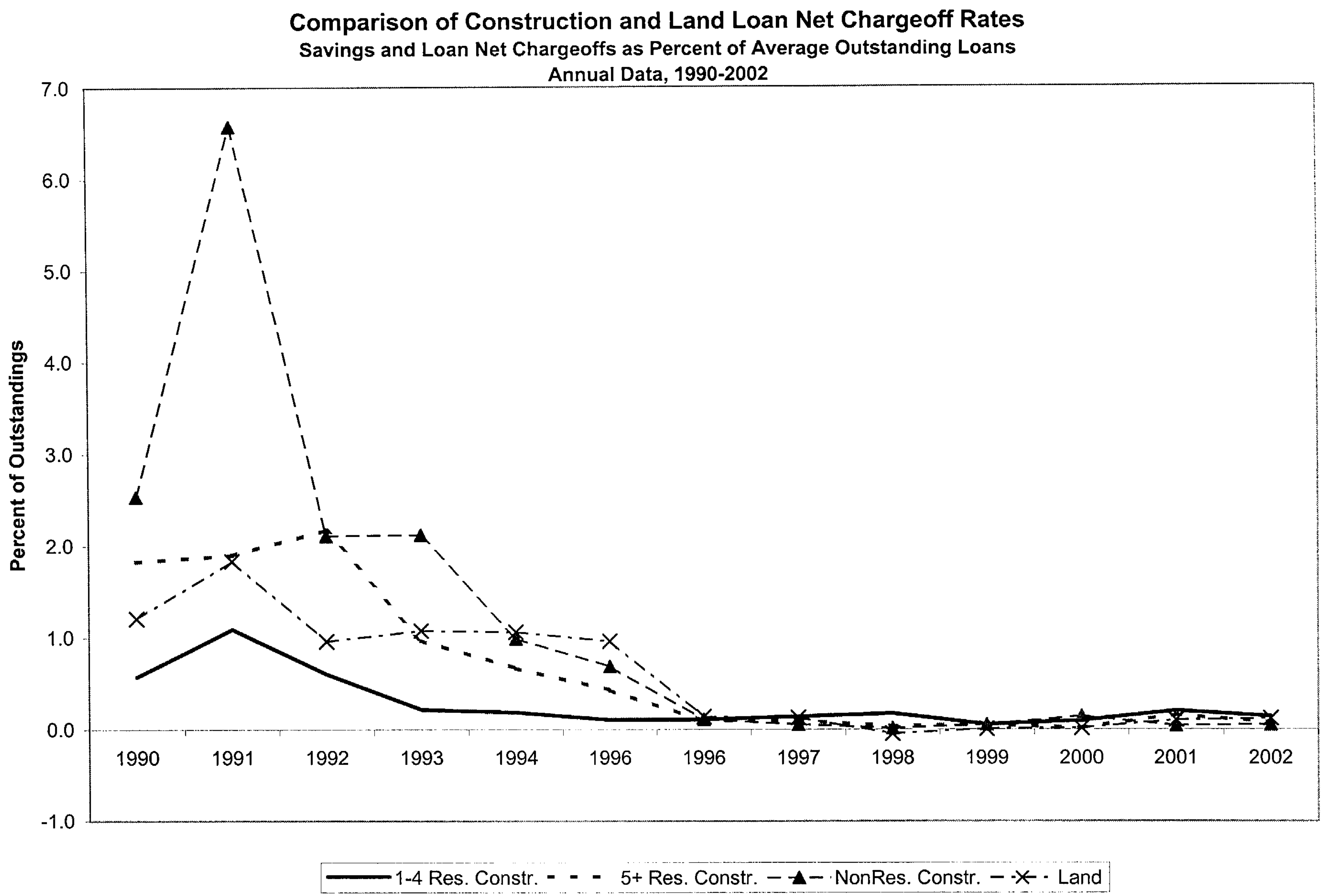
Home Mortgage and Construction Loan Performance

Savings and Loan Net Chargeoffs as Percent of Average Outstanding Loans

Annual Data, 1990-2002



Source: Office of Thrift Supervision, Compiled by NAHB

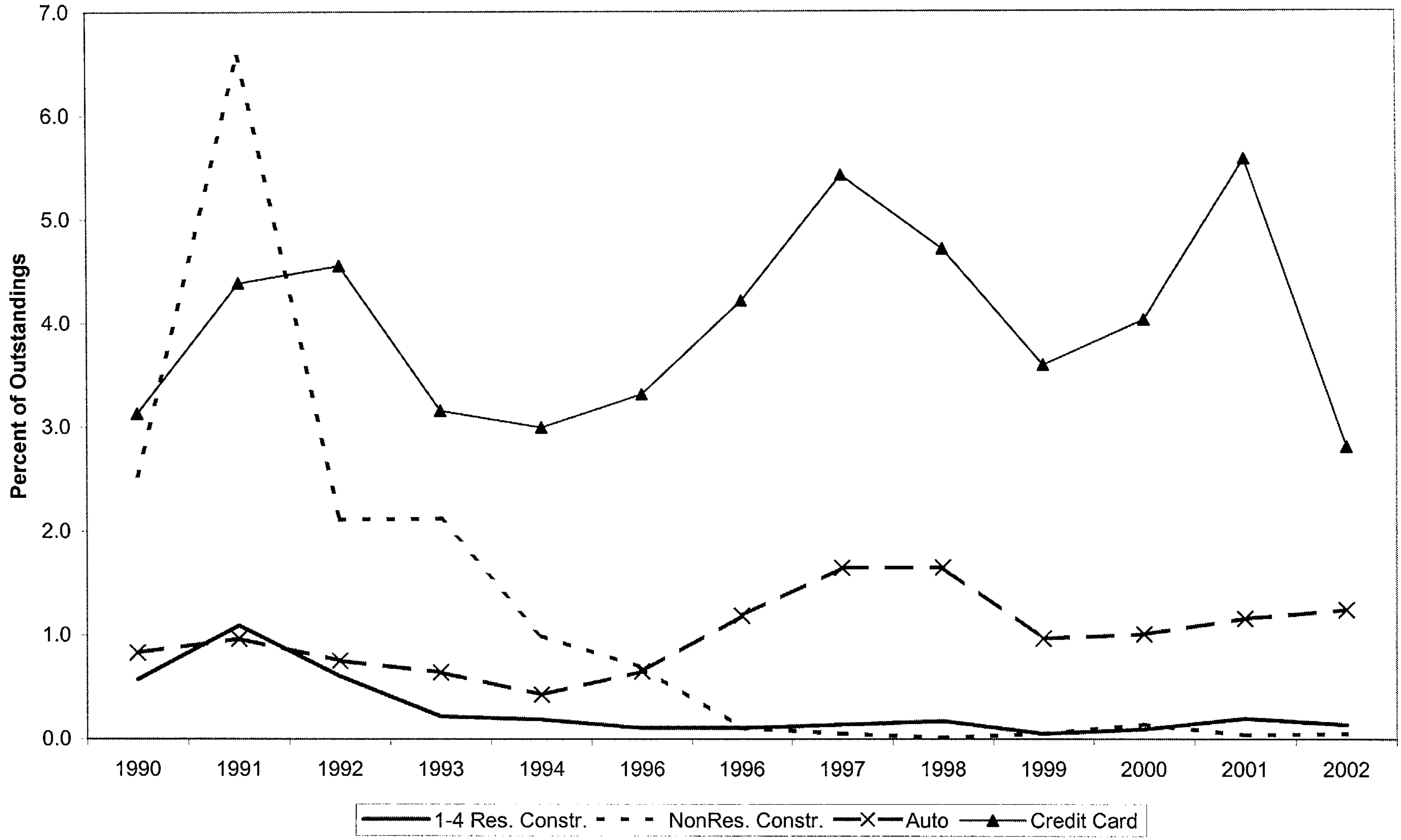


Source: Office of Thrift Supervision, Compiled by NAHB

Performance of Home Construction Loans Relative to Other Loan Types

Savings and Loan Net Chargeoffs as Percent of Average Outstanding Loans

Annual Data, 1990-2002



Source: Office of Thrift Supervision, Compiled by NAHB

Net Chargeoffs as Percent of Average Loan Amount - By Loan Type for all OTS Thrifts
Annualized from Quarterly Data

Year	Percent of 1-4 Res. Mtg. Mtg. Loans	Percent of 1-4 Res. Constr. Loans	Percent of 5+ Res. Mtg. Mtg. Loans	Percent of 5+ Res. Constr. Loans	Percent of NonRes. Mtg. Mtg. Loans	Percent of NonRes. Constr Constr. Loans	Percent of Land Loans	Percent of Comm. Loans	Percent of Auto Loans	Percent of Credit Card Loans
1990	0.098	0.575	0.835	1.829	1.389	2.533	1.208	1.310	0.829	3.131
1991	0.135	1.091	0.610	1.898	1.166	6.574	1.836	2.190	0.963	4.386
1992	0.211	0.603	0.724	2.176	1.321	2.110	0.960	1.455	0.751	4.554
1993	0.416	0.217	0.844	0.971	1.629	2.119	1.076	3.067	0.641	3.154
1994	0.268	0.186	1.446	0.667	1.168	0.989	1.059	0.902	0.426	2.993
1996	0.188	0.105	0.644	0.427	0.781	0.684	0.959	0.674	0.651	3.312
1996	0.209	0.107	0.524	0.088	0.392	0.106	0.135	0.314	1.185	4.212
1997	0.156	0.139	0.183	0.098	0.084	0.052	0.126	0.382	1.646	5.424
1998	0.103	0.173	0.068	0.032	0.087	0.014	-0.045	0.447	1.648	4.711
1999	0.067	0.052	-0.069	0.053	0.042	0.052	0.006	0.473	0.964	3.592
2000	0.049	0.094	-0.033	0.013	0.040	0.141	0.012	0.946	1.004	4.024
2001	0.057	0.198	0.001	0.155	0.188	0.040	0.100	1.348	1.155	5.575
2002	0.055	0.138	0.000	0.073	0.111	0.049	0.114	1.536	1.239	2.803
Average	0.155	0.283	0.444	0.652	0.646	1.189	0.580	1.157	1.008	3.990