NATIONAL ASSOCIATION OF REALTORS®

The Voice For Real Estate®

REALTOR®

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<u>Via facsimile (41 61 2809100/8100)</u>

July 30, 2003

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

Re: The Third Consultative Paper on the new Basel Capital Accord

Dear Basel Committee Member:

The NATIONAL ASSOCIATION OF REALTORS® (NAR), representing over 900,000 real estate practitioners, would like to submit the following comments on the Third Consultative Paper on the new Basel Accord. The NATIONAL ASSOCIATION OF REALTORS®, *The Voice for Real Estate®*, is the world's largest professional trade association. NAR is composed of REALTORS® who are involved in residential and commercial real estate as brokers, salespeople, property managers, appraisers, counselors, investors, developers and others engaged in all aspects of the real estate industry.

Members belong to one or more of some 1,700 local associations/boards and 54 state and territory associations of REALTORS®. Additionally, thousands of REALTORS® are members of NAR's many institutes, societies and councils, designed to enhance their expertise and network with other professionals globally. These include the Certified Commercial Investment Member (CCIM), the Institute of Real Estate Management (IREM), the REALTORS® Land Institute (RLI), the Council of Real Estate Brokerage Managers (CRB), the Council of Residential Specialists (CRS), the Real Estate Buyer's Agent Council (REBAC), the Society of Industrial and Office REALTORS® (SIOR), the Counselors of Real Estate (CRE) and the Women's Council of REALTORS® (WCR).

As international developments have played an increasing role in how and where capital is invested throughout the world, NAR has expanded global real estate market opportunities for its commercial and residential members. Since NAR started its international operations program in the early 1950s, the association has built a network of cooperative agreements with real estate associations around the world, and has actively expanded and developed this network. NAR has promoted international real estate education, development of technical standards and technical information exchange, and international real estate practice in a number of areas, including commercial outreach activity and development of an international real estate consortium.

NAR took a leadership role in helping organize the International Consortium of Real Estate Associations (ICREA) in 2001. ICREA's mission is to assist constituent members to efficiently serve their customers and clients through the development and maintenance of international business standards, products and services. Objectives of the consortium include technical standards for data transfer, an international referral system and advocacy, including promoting best practices worldwide.

Basel II Accord

NAR still supports the overall goal of Basel II, which is to create regulatory capital standards that are more aligned with the underlying economic risks that a bank will incur. Basel II will permit qualifying institutions to calculate their minimum risk-based capital requirements by using their own internal risk estimates, which we believe will promote strong risk management. The Accord is intended to provide an incentive for banks, in the form of lower capital requirements, to employ sophisticated modeling techniques, loss mitigation tracking tools and risk modeling tools. NAR believes that the objectives for Basel II are important to ensure consistency and competitiveness among internationally active and domestic banks, particularly those that engage in real estate lending.

We believe, however, that the Third Consultative Paper still poses some adverse consequences for residential and commercial lending. Even though the capital charges on certain types of commercial real estate loans have been revised by providing for optional treatments based on national discretion in the Third Consultative Paper, the fact that real estate lending is treated differently overall will lead to a loss of credit opportunities in that sector. Real estate is vital to the U.S. economy because the housing sector directly accounts for about 15% of the total production and an additional 6% of economic activity is derived from indirect housing-related expenses.

The Basel II Accord consists of three pillars, the most important of which is Pillar I. This Pillar consists of minimum capital requirements, which are the rules that a bank uses to calculate its capital ratios. The Pillar I capital requirement includes a credit risk charge that is measured by either a Standardized Approach or the Internal Ratings-Based Approach (IRB).

Credit Risk Under the Standardized Approach

Under the Standardized Approach, capital requirements will be determined by assigning a range of possible asset risk weights for the bank to apply, based on the types of loans and assets that the bank holds. The Standardized Approach establishes fixed risk weights that correspond to each category of loans and makes use of external credit assessments to determine the level of risk.

In the Third Consultative Paper, under the Standardized Approach, lending fully secured by mortgages on residential property that is or will be occupied by the borrower or that is rented will be risk weighted at 35% as compared to 40% in the Second Consultative Paper. NAR supports this change. However, the risk weight for development and construction loans where the source of repayment is either the future sale or leasing of the property is still 100%. As a result, when Basel II goes into effect pre-solds and multifamily dwellings will see their risk weight doubled because currently under Basel I these exposures are risk weighted at 50%.

NAR is concerned that the increased capital requirements for loans to this sector will trigger a credit reallocation away from residential real estate to those sectors with more appealing risk weights. If banks are forced to endure heightened capital charges, they will be at a distinct competitive disadvantage when competing against non-banks in this market as well as against those banks qualifying for the Internal Ratings-Based Approach.

Also, under the Standardized Approach loans secured on some commercial real estate will require a 100% risk weighting. Regardless of the credit worthiness of the borrower, a loan secured by commercial real estate will automatically be risk weighted at 100%. As with residential real estate, this will create a disincentive to lend in this sector. Again, if a bank chooses to continue lending to this sector, it will be at a distinct competitive disadvantage to non-banks not subject to the Accord's requirements and to those banks receiving lower risk weights under the Internal Ratings-Based Approach.

Credit Risks Under the Internal Ratings-Based Approach (IRB)

Even though the capital charges that IRB banks must incur in regards to real estate lending is somewhat improved in the Third Consultative Paper, NAR believes that real estate is still adversely affected as compared to other types of loans under the IRB approach.

The IRB approach allows a bank to use sophisticated internal credit risk rating models and systems to measure capital adequacy. The IRB approach includes a foundation internal ratings based approach version and an advanced internal ratings based approach version. The foundation version means a bank has a system in place to accurately estimate for each credit exposure the probability that the borrower will default. Under the advanced approach, besides estimating the probability of default, a bank would have to estimate the likely size of the financial loss in the event of a default and an estimate of what the total amount borrowed would be at the point a likely default would occur.

Under the IRB approach, banks would have to classify their exposures into broad classes of assets. These classes include sovereign, bank, retail, equity and corporate. Within the corporate asset class there are five subclasses of specialized lending including project finance, object finance, commodities finance, income-producing real estate, and high-volatility commercial real estate. Income producing real estate refers to a method of providing funding to real estate such as multifamily buildings where the prospects for repayment of the loan depends on the rental payments coming in from the tenants or the sale of the building. High-volatility commercial real estate lending is the type of lending that could experience higher loss rate volatility (i.e., higher asset correlation) compared to other kinds of specialized lending.

Even though real estate lending is still divided into income producing real estate and high-volatility commercial real estate categories, a significant departure from the Second Consultative Paper is the fact that the risk weight for both of these categories can now be calculated under the formula for the corporate asset risk class. If a bank qualifies to use the IRB approach then it can use the corporate asset risk class formula to determine the risk weights for income producing real estate and high-volatility commercial real estate. However, for high-volatility commercial real estate, banks will also have to apply a substitute asset correlation formula in lieu of the asset correlation function currently assigned to the corporate risk class formula. The reason for the substitute asset correlation formula is the belief that high-volatility commercial real estate loans tend to default at the same time, which necessitates higher capital requirements.

Only residential and commercial construction loans are included as high-volatility commercial real estate under the corporate asset exposures. These are loans where the source of repayment on the loan is dependent on the future sale of the property or cash flows from unknown sources. In other words, a construction loan on a pre-sold home would incur the same capital charge as a loan to build a large commercial development whose future tenants are unknown. NAR believes that this will cause banks not to provide acquisition, development and construction loans because these loans will have the same capital expense as those associated with more risky lending activities.

NAR contends that improvements in underwriting such as requiring more borrower equity, better appraisal procedures and improved credit scoring techniques have made commercial real estate lending less volatile, as demonstrated by the industry's reduced loan loss experience over the last ten years or so. Also, through securitization vehicles like commercial mortgage backed securities (CMBS), real estate's role in the global markets has increased which has led to better transparency and discipline, greater liquidity and a closer examination of commercial lending activity worldwide. NAR would encourage the Basel Committee to categorize all commercial real estate as income producing and eliminate the high-volatility commercial real estate category.

Banks that fail to qualify to use the IRB approach will have to use the preset minimum numerical capital ratios contained in the Second Consultative Draft to determine the risk weights for income producing real estate and high-volatility commercial real estate. As a result, the specific risk weights could range from 75% to 625% for income producing real estate and 100% to 625% for high-volatility commercial real estate. In other words, if a bank cannot use the IRB approach then it will incur higher capital charges for income producing real estate and high-volatility commercial real estate. As before, these risk weights seem to be arbitrarily high and not reflective of the advancements made in lending to this sector.

Competitive & Cost Disadvantages for Smaller Banks and Inconsistent Worldwide Enforcement

Basel II will give some degree of regulatory capital relief to a limited number of banks that qualify, in exchange for investing in systems and infrastructure intended to improve risk management. NAR is concerned that this will enable only the largest banks that can invest in sophisticated capital allocation models, to effectively operate with a lower capital ratio than smaller banks. These banks will be able to grow and compete more aggressively for both assets and liabilities to the disadvantage of smaller banks.

Small banks do not have the resources to implement the complex internal risk weighting models that the Basel II Accord requires. The estimates range from $50 million to $200 million per bank to implement the procedures required under Basel II to evaluate and control risk exposures. The costs associated with learning a new regulatory system, installing new software and retraining staff will be prohibitive to small banks. Small banks could become acquisition targets of Basel II banks, which could result in further consolidation of the industry. NAR believes that maintaining competitive equality for smaller banks is important.

Finally, NAR is concerned that foreign banks will have a competitive advantage because the prescriptive capital rules could be haphazardly enforced outside the United States while being strictly enforced here. Similarly, it is foreseeable that there will be great difficulties in applying a complex set of rules equally across a wide array of banking systems throughout the world. In this regard, it seems the complexities of Basel II will work against the goals of the original Accord.

Conclusion

Though the Third Consultative Paper is an improvement over the Second one, NAR is still concerned that under the Basel II Accord financial institutions will divert their resources away from real estate lending and make loans to those sectors that do not require as much capital. If Basel II is enacted as currently written, banks whose portfolio is now geared toward real estate lending will refocus their lending strategies away from real estate and towards those promising more attractive capital charges.

NAR would encourage more analysis of the underlining assumptions in the proposed Basel II Accord. We urge the Committee to continue to reexamine the treatment of real estate lending under the Basel II Accord and the potentially adverse consequences it will have on the real estate sector.

NAR appreciates the opportunity to comment on the Basel Committee on Banking Supervision's Third Consultative Paper and if you have any questions please contact Peter Morgan at 202-383-1233 or pmorgan@realtors.org.

Respectfully Submitted,

David Lereah
Senior Vice President & Chief Economist

cc: Board of Governors of the Federal Reserve
Federal Deposit Insurance Corporation
Office of the Comptroller of the Currency