Basel III Bank Capital Proposal – MBA Summary

I. Introduction/Background

On July 27, the Federal Reserve, Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (Banking Agencies) issued a Notice of Proposed Rulemaking (NPR) implementing the final aspects of Basel III and making certain changes to the U.S. bank capital rules. In aggregate, the proposal would increase minimum regulatory capital requirements for U.S. banks with total assets of greater than $100 billion by 15-20 percent.

MBA believes that the NPR poses unwarranted risks to the U.S. economy, to housing and real estate markets specifically, and contradicts many of Biden Administration's policy goals, including for affordable housing (ownership and rental), bank competition over consolidation, and closing the racial homeownership and wealth gaps. It is still unclear how the NPR interacts with other regulatory proposals (e.g., CRA final rule, proposed FSOC designation guidelines, Basel Liquidity Coverage Ratio, and Net Stable Funding Ratio), and how it could ultimately stunt credit access to support the creation of more affordable ownership and rental housing from the largest providers of capital in the country.

It is also unclear what specific problems the NPR is trying to solve, considering that the Federal Reserve and Treasury have consistently stated that the banking system is strong – capital ratios of large banks operating in the U.S. have more than doubled since the Great Financial Crisis, and more than a decade of real-life experience has demonstrated that banks have adequate capital to withstand significant economic shocks. In fact, recent stress test results confirm that the banking system is safe and well-capitalized.

The proposed rule also lacks the robust economic impact analysis that usually accompanies such a significant change in bank capital standards – a scant 15 pages of impact assessment out of nearly 1,100 pages. The analytical shortcomings were a significant factor in the very close votes at the FDIC and Federal Reserve Board prior to the NPR's issuance. Previous proposed capital rules implementing Basel were unanimously approved by the Banking Agencies. The lack of unanimity for this proposed rule could presage calls for the Banking Agencies to complete a quantitative impact study (QIS) for stakeholder review before moving to a final rule. In dissent, FDIC Commissioner Jonathan McKernan stated the following: "*There likely will be real economic costs. Large banks generally would see an increase in the capital requirement on mortgage loans to borrowers who cannot afford a 20% down payment. The increased capital requirements could lead to an increase in interest rates*

for low- and moderate-income and other historically underserved borrowers who cannot always afford a 20% down payment, making it that much harder for these families to achieve homeownership."

The Banking Agencies have stressed the fact that they provided an extended comment period (120 days) as well as a three-year implementation phase-in to ameliorate the harsh impact of the proposed changes. Prior experience with major changes in capital rules suggests that market pressure will force banks to start complying with the new requirements long before the rule is finalized. This puts a high stakes premium on getting the final rule right.

II. High-Level Summary

- The NPR results in an overall capital increase for banks with total assts of $100 billion or more. As noted above, this increase in capital will have an impact on the housing sector. Impacted banks will reduce overall lending and adjust business lines – those higher capital requirements relative to returns could see a pullback.
- According to the limited impact analysis, the proposed rule would increase minimum Common Equity Tier One (CET1) by:
  - 16% for all large bank holding companies (BHCs)
  - 9% for all large banks.
  - 19% for Category I and II BHCs
  - 6% for Category II and IV banks

  - The NPR aligns capital rules for institutions with assets between $100 billion and $700 billion (Category III/IV) with GSIBs and other large organizations (Category I/II). Therefore, like Category I and II banks, Category III and IV banks would be:

Limited on the amount of threshold items that can be included in regulatory capital to 10% individually, and an aggregate of 15%.[1]
Required to include all components of Accumulated Other Comprehensive Income (AOCI), including unrealized gains/losses in AFS portfolio in regulatory capital.[2]
Subject to other regulatory capital deductions that are applicable to Category I and II banks, such as deduction of any amount of the bank's nonsignificant investments in the capital of unconsolidated financial institutions that exceeds 10% of the bank's CET1.
Subject to total loss absorbing capacity (TLAC) holdings deduction treatments.

[1] Threshold items include MSRs, MSAs, temporary difference DTAs that the banking organization could not realize through net operating loss carrybacks, and investments in the capital of unconsolidated financial institutions.
[2] "[e]xcept gains and losses on cash-flow hedges where the hedged item is not recognized on a banking organization's balance sheet at fair value."

Subject to the supplementary leverage ratio requirement, and 2) the countercyclical capital buffer requirements that are currently applicable to Category I, II and III banks.

- The NPR does not make any changes to the risk weighting for Ginnie Mae MBS (currently risk weighted at 0%) and Fannie Mae/Freddie Mac MBS (currently risk weighted at 20%). Given the complexities of the rule, the impact on traditional private label securitizations requires further analysis.

III. Provisions Directly Impacting Real Estate Finance

Single Family Residential Mortgages

The NPR assigns higher risk weighting to "regulatory" residential mortgages[3] based on a loan's loan-to-value (LTV) ratio and depending on whether the loan is dependent on the cash flows generated by the real estate.[4]

Proposed risk weights for regulatory residential real estate mortgages that are not dependent on the cash flows of the real estate

LTV Ratio	< 50	50-60	60-80	80-90	90-100	>100
Current U.S. Rules	50%	50%	50%	50% (with MI)	50% (with MI)	50% with MI)
Basel R/W	20%	25%	30%	40%	50%	70%
NPR R/W	40%	45%	50%	60%	70%	90%

Proposed risk weights for regulatory residential real estate mortgages that are dependent on the cash flows of the real estate

LTV Ratio	< 50	50-60	60-80	80-90	90-100	>100
Current U.S. Rules	50%	50%	50%	50% (with MI)	50% (with MI)	50% with MI)
Basel R/W	30%	35%	45%	60%	75%	105%
NPR R/W	50%	55%	65%	80%	95%	125%

For single-family home loans, current U.S. standards apply a 50% risk weight for "well underwritten" mortgages – typically Qualified Mortgage (QM) loans, and with mortgage insurance if the LTV exceeds 80%. There is no distinction for owner-occupied versus

[3] Defined as a first-lien residential mortgage.

[4] The NPR assigns risk weightings depending on whether the loan is (i) secured by a property that is either owner occupied or rented; (ii) made in accordance with prudent underwriting standards (iii) for which the bank applied underwriting policies that account for the ability of the borrower to repay based on clear and measurable underwriting standards; and (iv) the property is valued in accordance with the proposed requirements included in the proposed LTV ratio calculation.

income property. The international Basel framework has instead used graduated risk weights by LTV. For reasons not clearly explained, the Banking Agencies chose to "gold plate" the Basel risk weights for home mortgages by adding 20 percentage points across the board and providing no credit for mortgage insurance. As a result, large banks will face higher capital requirements than current rules for loans with LTVs greater than 80%. In addition, the GSIBs – which had used internal models for their risk weighting – likely will face higher capital across the board for mortgages.

Commercial Mortgages

While the NPR maintains the current risk-weighting standard for statutory multifamily mortgages, it proposes a striation of risk-weightings for commercial mortgages that are current based upon the loan-to-value (LTV) ratio. The proposal changes how a defaulted mortgage is defined, including exposure to the borrower. Please see the below chart for the proposed risk weight changes to commercial mortgages.

Proposed risk weights for commercial real estate mortgages that are dependent on the cash flows of the real estate[1]

Current R/W Standard	NPR R/W Standard
Statutory multifamily mortgages.[2] An FDIC-supervised institution must assign a 50% risk weight to a statutory multifamily mortgage.	No change
Current Commercial Loans (not statutory mortgages). *100%*	LTV[3] less than or equal to 60% - R/W 70% LTV greater than 60% but less than or equal to 80% – R/W 90% LTV greater than 80% – R/W 110%
Other Commercial Loans (not within definition of CRE) *150%*	No change
Non-current commercial (90 days or more past due and not otherwise guaranteed or secured) – 150%	Changes how defaulted mortgage is defined. For commercial mortgages, the bank must analyze exposure to the borrower. 150% RW is assigned to any defaulted loan and essentially all other

	loans to the same borrower (even if current).
Pre-sold construction loans. 50% to a pre-sold construction loan unless the purchase contract is cancelled, in which case 100%.	No change
High-volatility commercial real estate (HVCRE) exposures. 150%	No change
New risk weight	***Acquisition, development, or construction (ADC) exposures that are not HVCRE.*** 100%

[1] For commercial owner-occupied loans: LTV less than or equal to 60% - lesser of 60% or R/W applicable to borrower and LTV greater than 60% - R/W appliable to borrower.
[2] In general, a "statutory multifamily mortgage" is a loan secured by a first lien on a multifamily residential property that meets the following criteria: Made in accordance with prudent underwriting standards; Amortization must occur over not more than 30 years; Minimum original maturity for repayment of principal must not be less than 7 years; Loan principal at origination does not exceed: 80% of the property value for a fixed rate loan and 75% of the property value for a variable rate loan; and DSCR of at least 1.20 for fixed rate loans and 1.15 for variable rate loans.
[3] Per the NPR, LTV should be calculated using total outstanding amount of the loan and the value of the property at the time of origination.

IV. Macro Implications for Housing

The proposals in the NPR are of critical importance to the mortgage industry because the amount of capital a bank must maintain with respect to any loan is typically a significant – if not the most significant – factor in determining whether a business line provides an adequate return on capital. In recent years, bank origination of residential mortgages and mortgage servicing rights (MSRs) holdings have been declining, and the NPR would add further strain to the already stressed situation.

This is particularly true for MSRs, which under current rules already face a punitively high 250% risk weighting and require deductions from capital to the extent MSRs exceed 25% of CET1 (10% for GSIBs). The NPR would align the treatment of MSRs at the large regional banks with the lower 10% cap for GSIBs, making MSRs even more unattractive to those banks. This could reduce demand for MSRs, impacting liquidity and MSR values not just for banks but for all market participants.

Independent Mortgage Banks (IMBs) that now fill the gap in mortgage originations and MSR holdings rely on banks for funding for their originations, MSR holdings, servicing, hedging, and securitization activities. The proposed capital changes in the NPR could impact this bank funding for IMBs in a way that could in turn hurt the housing market.

The NPR will reduce interest in mortgages for banks' balance sheets, including high LTV Affordable lending (due to increased costs), and puts more pressure on the GSEs and Ginnie Mae.

Furthermore, MBA continues to be concerned about the risk weighting assigned to warehouse lines, which do not correlate with the underlying mortgage loans backed by the lines. We believe that increased capital requirements for warehouse lines would discourage banks from offering them – to the detriment of the housing market.

V. Timing Implications

The Banking Agencies have consistently stressed the generous 120-day comment period and extended implementation timeframe provided in the NPR. Regardless of the extended implementation timeframe, equity markets will react immediately, and banks will respond to that pressure in real time, long before the final rule is fully phased in. Similarly, the Banking Agencies have minimized the impact by noting that "most institutions" already meet the standards. However, no bank chooses to operate without a capital cushion, and the proposed rule will force all institutions to raise significant new capital to maintain their current buffers above their regulatory minimum.

VI. Additional Observations and Notes

- The NPR's increase in capital requirements will effectively impact which lines of business banks choose to support or withdraw from. Moreover, these increases in capital standards will likely stunt macroeconomic growth and reduce banks' participation as single-family and commercial/multifamily lenders, servicers, and as providers of warehouse lines and mortgage servicing rights financing.
- The NPR's lack of credit for mortgage insurance coverage in risk-weighting will further hinder banks from making higher LTV loans. The industry's risk distribution with respect to MI is a positive that should be considered.
- The NPR's further punitive capital treatment of bank holdings of MSRs will exacerbate the trend of banks leaving the servicing market, which will reduce MSR liquidity/values, increase costs for warehouse and MSR financing for IMBs, further constraining liquidity.
- The NPR increases concern that FHFA and Ginnie Mae – under pressure from the bank regulators on FSOC – could seek to extend these poorly conceived capital standards to IMBs.
- The NPR's development process lacked transparency and meaningful public input (especially due to the absence of a QIS or an ANPR prior to the issuance of the NPR.

- The NPR is inconsistent with the Basel Agreement's goal of harmonizing capital requirements internationally.
- The NPR essentially repeals important sections of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA or S.2155). This is very problematic, considering that the industry worked with the Banking Agencies for years resulting in the sections that are now repealed under this NPR.
- The NPR's change in the definition of defaulted commercial mortgages and inclusion of current mortgages by the same borrower as defaulted is problematic and inconsistent with the risk exposure to current commercial loans dependent on the cash flows of the property securing the loan.
- The NPR will result in increased borrowing costs and reduce credit availability, which could in turn lead to a decline in market liquidity in critical markets and harm a variety of end users, including first time home buyers, LMI borrowers with smaller down payments, as well as small businesses.
- Given ongoing affordable housing challenges, regulators should be taking steps that encourage banks to better support real estate finance markets. The NPR does precisely the opposite during a time of near record-low single-family delinquencies and pristine underwriting
- MBA strongly opposes key elements of the NPR and will work with our members and other industry stakeholders to formulate our full response, which will include recommendations to mitigate the adverse impacts to borrowers and single-family and commercial/multifamily markets.