MORTGAGE BANKERS ASSOCIATION ❖ CRE FINANCE COUNCIL ❖ NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS ❖ THE REAL ESTATE ROUNDTABLE ❖ CCIM INSTITUTE ❖ INSTITUTE OF REAL ESTATE MANAGEMENT ❖NATIONAL ASSOCIATION OF REALTORS® ❖NATIONAL MULTIFAMILY HOUSING COUNCIL ❖ ASIA PACIFIC REAL ESTATE ASSOCIATION

March 27, 2015

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 signatories[1] appreciate the opportunity to comment on the Basel Committee on Banking Supervision's (Basel Committee) Consultative Document titled *Revisions to the Standardised Approach for Credit Risk* (Consultative Document).[2] The Consultative Document is for determining the appropriate risk-weighting regime for credit exposures for those using the standardized approach. The joint trades believe that the Consultative Document, as drafted, will potentially impact bank lending in a deleterious manner, and by extension, national economies, as well.

While we support standards by which real estate lending is sensibly underwritten and economic risk is appropriately priced, certain proposed capital increases, coupled with rules that are not appropriately linked to economic risks, could have negative consequences for lending to real estate and affected economies. We urge the Basel Committee to carefully study the impact of the proposed regime on commercial real estate credit capacity, market liquidity and the broader economies. We first provide our perspective on the overall regulatory environment and then provide our recommendations regarding the treatment of commercial and multifamily real estate lending.

Banking Regulatory Environment

The banking industry is absorbing a great number of regulations at this time and will be doing so through 2019. For U.S. banks, the rollout of Basel III included updates to the definition of

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[1]Mortgage Bankers Association, CRE Finance Council, National Association of Real Estate Investment Trusts, The Real Estate Roundtable, CCIM Institute, Institute of Real Estate Management, National Association of Realtors®, Asia Pacific Real Estate Association, and National Multifamily Housing Council, collectively, the joint trades.
[2]Basel Committee on Bank Supervision, Consultative Document, Standards, Revisions to the Standardized Approach for Credit Risk, December 2014.

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. Additionally, regulations involving commercial mortgage-backed securities were recently finalized for risk retention[3] and Regulation AB[4].

Rules are complex and often require that regulators analyze implementation across institutions, provide re-direction to individual banks, resulting in refinements in treatment. In this environment of rapid change, covered institutions have been approaching regulatory implementation in a spirit of conservatism. Many bank members have described a system in which the outer bound regulatory benchmark for a given bank can change dynamically, even quarterly, causing the attractiveness, and even the viability, of businesses to be viewed differently from one period to the next. Given the layered interaction of these rules, the impacts on pricing, credit availability, liquidity, and other critical features of the financial system will not be known for years. There is ample evidence to suggest that financial institutions decrease lending in the face of uncertainty about returns, which will have potentially harmful effects on the economy. The merits of additional regulatory regime changes contemplated by the Consultative Document should be carefully weighed against the existing regulatory implementation challenges that U.S. banks are currently facing.

The joint trades understand and support the fact that Basel III, and other reforms, is intended to better insulate financial institutions and real economies from outsized crises, such as the Great Recession. At the same time, it has to be acknowledged that deleveraging dampens economic activity. Especially given the global struggle to return to healthy growth rates, it is imperative that the Basel Committee and local regulators strike a balance between credit availability and sensible underwriting.

In this environment of slow growth and regulatory conservatism, the joint trades would encourage regulators to balance their prudential goals with the need to retain some flexibility in the regulatory framework. The chief way this can be achieved within the context of the Consultative Document is to maintain aggregate Basel III requirements. Consistent with this and addressed below are the joint trades' views regarding the portions of the Consultative Document that address risk weights for commercial real estate (CRE) and multifamily loans.

[3] Fed. Reg. Vol. 79, 77602, (December 24, 2014).
[4] Fed. Reg. Vol. 79, 571842, (September 24, 2014)

Proposed Treatment of Commercial Real Estate Loans

Treatment of Commercial Real Estate Loans Structured as SPEs

Within the commercial real estate setting, Special Purpose Entities (SPEs) are a tool used mostly by real estate developers and owners ("Sponsor") of operating (CRE) properties to isolate tort risk, facilitate cleaner ownership structures among various individuals and entities, and to make their projects attractive to commercial lenders. The use of a SPE enhances the "financeability" of a real estate project because it gives the lender greater comfort that the primary asset—the real estate project itself—will be shielded from many events that might prevent the lender from foreclosing on its loan.[5] In addition, for CRE loans, SPE's are typically passive, with the borrower (Sponsor), not the SPE, making the operational decisions for the property. The SPE does not shield the borrower from malevolent acts, should the bank repossess the property. Moreover, recourse can be, and often is, established as a term of the loan. Because the SPE feature is neutral to the credit risk in the loan and because it is instrumental in lowering operational risk, the structure is preferred by banks.

According to the Consultative Document, a CRE loan structured as a SPE would be classified as "specialized lending" if "The exposure is typically to an entity (often a special purpose entity (SPE) that was created specifically to finance and/or operate physical assets "[6]. As specialized lending, a CRE loan structured as an SPE would fall under the income producing real estate (IPRE) subcategory.[7] The Consultative Document indicates that IPRE exposures will be risk-weighted at the higher of (1) the risk weight of the applicable counterparty, and (2) 120 percent.[8] This would result in a risk weight of at least 120 percent, or 20 percent higher than the existing 100 percent risk weight.

Given that the SPE structure is beneficial to and is a fundamental element of CRE lending, we are strongly concerned that the Consultative Document would provide for a punitive risk weight for SPEs. In fact, this is counter to the direction that U.S. regulatory agencies took when considering the 100 percent outflow treatment (the highest category) for CRE loans structured as SPEs in the Liquidity Coverage Ratio Final Rule:[9]

> The agencies have also revised the outflow rates for committed credit and liquidity facilities to SPEs so that only SPEs that rely on the market for funding receive the 100 percent outflow rate. This change should address commenters' concerns about inappropriate outflow rates for SPEs that are wholly funded by long-term bank loans and

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[5] Effective Use of Special Purpose Entities. David J. Sewell, (July 2006).
[6] Consultative Document, p. 33.
[7] See Consultative Document Specialized Lending subcategory IV, p. 34.
[8] Consultative Document, p. 34.
[9] Fed. Reg. 61444 (October 10, 2014).

> similar facilities and do not have the same liquidity risk characteristics as those that rely on the market for funding.

Importantly, U.S. regulators recognized that CRE loans structured through SPEs do not share the same risk characteristics as other types of SPEs. We would strongly encourage the Basel Committee to reach a similar conclusion and eliminate the punitive risk weight for CRE loans that are structured as SPEs. Instead, we believe that the structure of the CRE loan - a SPE or non-SPE – should not be a material consideration in assigning the risk weight.

<u>Proposed Treatment of Commercial Real Estate Loans</u>

Basel III rules in the United States require that CRE exposures receive a risk weight of 100 percent unless they are deemed to be high volatility commercial real estate exposures (HVCRE). HVCREs require a risk weight of 150 percent and are defined as any credit facility that finances or has financed the acquisition, development, or construction of real property unless the facility finances one-to-four-family residential mortgage property, or CRE projects that meet certain prudential criteria, including with respect to the LTV ratio and capital contributions or expense contributions of the borrower.

Under the current Basel standardized approach, the risk weight for a typical CRE loan is based on the collateral provided, and the risk weight is set at 100 percent. The existing regime also provides national discretion to reduce the risk weight to 50 percent under certain, strict conditions.

In the Consultative Document, the Basel Committee is considering two options:

1. No recognition of the real estate collateral. Rather, the exposure would be deemed to be unsecured, and the risk weight assigned based upon the strength of the counterparty – with weights from 60 percent to 300 percent of the exposure.
2. Assigning a risk weight from a table of risk weights ranging from between 75 percent and 120 percent based upon the LTV ratio. The proposed risk weights are as follows:

LTVs < 60 percent	Risk weight 75 percent
LTVs > or 60 percent but < 75 percent	Risk weight 100 percent
LTVs > or = 75 percent	Risk weight 120 percent

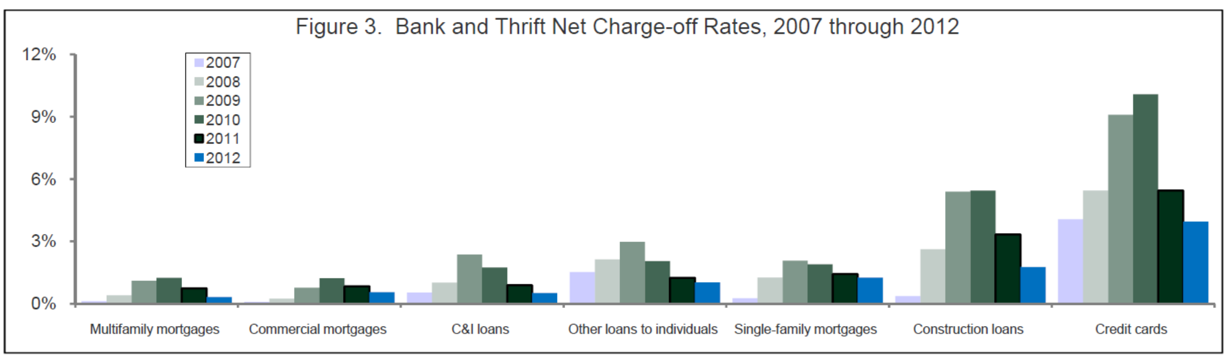
Regarding Option 1, the following rationale was provided in the Consultative Document:

> In view of the experience in numerous countries that commercial property lending has been a recurring cause of troubled assets in the banking industry over the past few decades, the Committee holds the view that commercial real estate collateral should not be considered a risk mitigant for regulatory purposes. As such, exposures secured by

> commercial real estate will be risk-weighted as unsecured exposures to the counterparty.[10]

We are concerned that this statement does not reflect the performance of U.S. bank holdings of CRE and multifamily loans during the most recent economic downturn. In a March 2013 Mortgage Bankers Association Research Datanotes[11] an analysis was performed regarding the performance of various bank asset categories that included: single family mortgages; credit cards; commercial and industrial loans; construction loans; other loans to individuals; CRE mortgages; and multifamily mortgages. In examining bank charge-offs during the 2007 to 2012 economic downturn, the report indicated:

> While delinquency rates represent the share of loans that are not paying on time, charge-off rates represent a bank's assessment of the share of the outstanding loan balance they are unlikely to get back….***Over the course of 2012, and throughout the credit crunch and recession, commercial and multifamily mortgages have had the lowest charge-off rates of any type of loan held by commercial banks and thrifts.*** In 2012, banks and thrifts charged off 0.55 percent of their balance of commercial mortgages and 0.32 percent of their multifamily mortgages, compared to charge-off rates of 0.84 percent and 0.74 percent respectively in 2011 (see Figure 3). By contrast depositories charged off 0.51 percent of their balance of commercial and industrial loans, 1.02 percent of other (non-credit card) loans to individuals, 1.26 percent of their one-to-four family residential loans, 1.77 percent of their construction loans and 3.95 percent of their credit card loans.[12]



For U.S. banks, the data shows that CRE and multifamily loans are clearly a risk mitigant. For construction loans, which experienced a higher charge–off rate for this period, U.S. regulators took action by instituting the HVCRE regime that increases the risk weight for acquisition, construction, and development loans that do not meet certain underwriting requirements. Given the strong performance of CRE and multifamily loans in the U.S., we do not share the

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[10] Consultative Document, p. 37

[11] See http://mba.informz.net/MBA/data/images/cmfdatanote030513.pdf

[12] MBA Research Datanotes, March 2013, p. 3, [Emphasis Added].

view that such exposures should be risk-weighted as unsecured exposures to the counterparty. In fact, we see a lack of empirical support for such an approach for U.S. banks.

In addition to the lack of empirical support, the assignment of the risk weight based upon the strength of the counterparty would be at odds with how CRE loans are frequently structured and analyzed by U.S. banks. U.S. bank CRE loan decisions are fundamentally driven by their assessment that the cash flow of the property will be able to adequately meet the debt service on the loan in a variety of market conditions and general valuation trends. This conclusion is reached by sophisticated and detailed underwriting of the property. While, the counterparty may be considered in the credit decision, they are rarely a definitive factor. In the event of a default, banks look primarily to the underlying asset value to recover the outstanding loan balance, not the counterparty.

Importantly, by only considering the counterparty in the risk weight, not the asset fundamentals, banks would be required to make CRE credit decisions based upon the strength of the counterparty coupled with their existing underwriting criteria. This could potentially skew bank lending decision towards low risk counterparties and to be potentially less sensitive to the quality of the properties themselves. Such a risk weight methodology has the potential to limit bank lending to worthy projects whose sponsors (counterparties) are in the above 100 percent risk weight categories. This option forgoes current underwriting criteria and fosters the potential for ill-considered CRE credit decisions.

The second option, loan-to-value ratio, more closely ties the risk weight to the existing bank credit decision process. When making CRE credit decisions, banks take into consideration a wide variety of factors. CRE underwriting is both an art and science. It is a combination of quantitative considerations (project financials, space configuration, current tenant base, etc.) and qualitative considerations (competitive position of the property, potential rent growth, surrounding area, etc). While the second option is far more aligned with the existing underwriting process than option one, additional consideration should be provided for the sophisticated and nuanced CRE lending underwriting process.

Should the Basel Committee move forward with the second option for additional consideration, we strongly recommend that the risk weight not exceed 100 percent and take into consideration existing CRE lending underwriting practices. Individual countries may have already established thresholds and requirements that duplicate the effects of outsized risk weights. As an example, Federal Reserve System issued CRE lending guidance leading into the peak that capped potential concentrations at the micro-level with tier I thresholds. Analysis of the market's reaction found that the policy was effective and indeed influenced certain institutions to reduce lending relative to trend[13]. Maintaining flexibility at the national level in addressing

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[13] Bassett, William F. and W. Blake Marsh; "Assessing Targeted Macroprudential Financial Regulation: The Case of the 2006 Commercial Real Estate Guidance for Banks", Finance and Economics Discussion

specific forms of outlier behavior will ensure that refinements to the standardized approach do not increase aggregate regulatory requirements for credit risk and that the economic impact of these proposed changes is neutral.

Acquisition, Development and Construction Lending

Page 12 of the Consultative Document proposed that acquisition, development and construction (ADC) lending be treated as "specialized lending". For specialized lending, the Basel Committee proposes to apply the higher of (a) the counterparty risk weight (determined on the basis of the counterparty's revenue and leverage) or (b) 150 percent against exposures to ADC loans.

Under Basel III in the U.S., 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 HVCREs (see above) and require a risk weight of 150 percent.

The joint trades believe that the rule in the U.S. better reflects the risks associated with ADC loans. 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. Thus, they get a risk weight of 100 percent. We urge the Basel Committee to consider using this approach when revising the Consultative Document. For the reasons previously described in the CRE and multifamily lending discussion, we strongly oppose the counterparty risk weight approach for CRE construction lending.

We encourage the Basel Committee to study the impact of the proposed rule on affected industries and economies and to provide the opportunity for continued industry comment on additional changes to the rules necessary to mitigate any sectoral and macroeconomic concerns.

Series Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board, 2014; http://www.federalreserve.gov/pubs/feds/2014/201449/201449pap.pdf

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The signatories greatly appreciate the Basel Committee's consideration of the remarks provided herein and invite the Basel Committee to contact the signatories individually or collectively to address any questions regarding this submittal.

Sincerely,

Mortgage Bankers Association
CRE Finance Council
National Association of Real Estate Investment Trusts
The Real Estate Roundtable
CCIM Institute
Institute of Real Estate Management
National Association of Realtors®
National Multifamily Housing Council
Asia Pacific Real Estate Association