Comment on the FRB, FDIC, and OCC Notice of Proposed Rulemaking

Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets, Market Discipline and Disclosure Requirements

RIN 1557–AD46 | RIN 7100 AD 87 | RIN 3064–AD96

October 22, 2012

Thank you for the opportunity to comment on the recent Notice of Proposed Rulemaking regarding implementation of the Basel III capital standards.

This comment is submitted by the Center for American Progress (CAP) and the other undersigned organizations and individuals. CAP is a progressive, nonpartisan think tank dedicated to improving the lives of Americans through ideas and action. CAP's housing team aims to preserve access to credit for all communities, prevent foreclosures, stabilize neighborhoods, and provide access to affordable, safe, and energy efficient rental housing. CAP also convenes the Mortgage Finance Working Group, which brings together experienced housing finance experts, affordable housing advocates, and leading academics. The group has been gathering since 2008 to better understand the causes of the mortgage crisis and create a framework for the future of the U.S. mortgage finance system.

We commend the Board of Governors of the Federal Reserve, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency for their focus on safety and soundness in the proposed rulemaking. Adequate capitalization is a critical component of any sustainable financial system. As the proposed rules emphasize, the financial crisis was characterized by excessive leverage and excessive risk-taking by financial institutions, as well as a lack of institutional capital standing behind credit risk. Strengthening institutional capital in our banking system provides an important foundation for a stronger, more stable economy.

While we generally support the higher capital standards in the risk-based capital levels, it is essential that those higher capital levels support a housing finance system that distinguishes between the reckless and over-leveraged activities of the financial industry that caused the crisis and the legitimate pursuit of long-term homeownership and affordable rental opportunities. Capital rules should promote safety and soundness by encouraging lenders to provide affordable and sustainable mortgage products to creditworthy borrowers, not by pushing certain borrowers out of the market entirely. The rules also should not discourage appropriate loan modifications to keep troubled borrowers in their home.

The risk-based capital rules should seek to foster the broad availability of safe and sound mortgages for single-family and affordable multi-family properties. Indeed, the ability to provide broad access to high-quality and prudent loans is an essential underpinning of a safe and sound banking system, because failing to serve borrowers or forcing borrowers to seek out riskier mortgages present destabilizing systemic risks.

For this reason, regulators should not establish unnecessarily onerous risk weights that have the potential side effect of driving mortgage lending out of banks. While the Consumer Financial Protection Bureau now has consumer protection jurisdiction across all mortgage originators, many of those originators are poorly capitalized and poorly regulated from a safety and soundness perspective. Systemic risks are increased if creditworthy households are driven away from the well-regulated sector or if their purchasing power is stifled by higher costs and lack of willing lenders.

What's more, only banks are subject to the Community Reinvestment Act, which has proven to be an effective and flexible tool for providing borrowers with access to credit, and which will only become more critical as we forge the housing finance system of the future.

We have a particular concern about discouraging banks from originating mortgages with down payments that are smaller than 20 percent. The size of a down payment can create a significant barrier to obtaining mortgage credit, and thus a barrier to homeownership.[1] This is especially true for low- and moderate-wealth borrowers. Research shows that it would take the typical family (earning a little more than $50,000) almost 14 years to accrue enough savings to put 20 percent down on a $150,000 home.[2] Similarly, many low- and moderate-wealth borrowers have limited credit histories and more difficulty meeting conventional debt-to-income ratios.

There is ample evidence that lenders can extend mortgage credit to low-wealth households in a safe and sound manner. Through their Community Reinvestment Act programs, depository institutions have a long tradition of originating loans for portfolio that did not meet the guidelines of the conventional secondary market, both because of underwriting and down-payment requirements. These loans have generally performed well despite lower down payments, lower credit standards, and more flexible underwriting requirements than the conventional market.

For example, a study by the UNC Center for Community Capital of nearly 50,000 mortgages funded in the decade leading up to the crisis by banks around the country under their CRA and affordable housing programs finds that these mortgages have remained profitable for the organizations involved even through the mortgage crisis. This result is even more remarkable given the profile of the borrowers; most put down *less than* 5%, half had credit scores under 680 at origination, and the median income was close to $31,000. [3] The loans in the study have performed well for the lenders and the families because of their extremely safe product features and origination channel: They were extended long-term, prime-market priced, fixed-rate mortgages, originated for ability to repay through retail depository institutions.[4]

With those principles in mind, we submit the following recommendations for your consideration:

1) Consider properly funded/capitalized/structured mortgage insurance and other credit enhancements when assigning risk-based weights based on loan-to-value ratios.
2) Focus risk categories on the sustainability of the loan product.
3) Ensure that risk-weighting rules do not discourage lenders and investors from modifying troubled mortgages to reduce risk of default or re-default.

4) Distinguish between different types of second liens when setting risk weights.
5) Expand the equity rules on multifamily loans to avoid disadvantaging loans for affordable housing.
6) Exempt small banks, community lenders, and Community Development Financial Institutions from changing their mortgage-related capital standards or at least do not require risk weights to be adjusted for existing mortgages.

1. Consider properly funded/capitalized/structured mortgage insurance and other credit enhancements when assigning risk-based weights based on loan-to-value ratios (Question 6).

As proposed, the new rules do not allow for any capital relief on high-LTV loans when the borrower has mortgage insurance or certain other forms of credit enhancement. For several reasons, we suggest reconsidering this decision.

First, mortgage insurance itself can be a form of capital, as it can cover losses in the case of a default. In a properly structured insurance model, this capital is directly dedicated to the high-LTV loans themselves and cannot be accessed for other purposes. The lender or investor stands to lose less if a borrower has mortgage insurance, so it makes sense for them to have to hold less of their own capital against a loan with mortgage insurance than one without.

Second, a key benefit of properly structured private mortgage insurance is that it shifts the collateral risk of higher-LTV lending from geographically-concentrated depositories to more geographically-diversified institutions. While the recent crisis was national in scope, local and regional market weakness is a far more likely risk than a national market collapse (especially in light of greater checks and balances on the mortgage finance system of the future). By pooling risks across institutions and geographies, mortgage insurance genuinely provides capital efficiency.

To be sure, the recent crisis exposed weaknesses in the mortgage insurance industry. During the bubble, mortgage insurance companies' underwriting standards deteriorated and they insured risky products and structures, ceded premiums to lenders under captive reinsurance schemes, and released capital when they should have been storing it. Today, the industry is sorely undercapitalized, some companies have stopped writing business, and several have reneged on claims for questionable causes.

At the same time, mortgage insurance companies did manage to pay approximately $30 billion in claims to the GSEs since 2007, materially offsetting taxpayer costs. Despite the experiences of some companies noted above, others continue to pay claims and two new entrants have arisen since the crisis have raised over $1 billion in capital.

In addition, regulatory constraints (from state regulators as well as the counterparty risk requirements of the GSEs) prevented these companies from pursuing many of the riskiest activities that marked the 2005-2007 period. For example, they lost substantial share to purchase-money seconds offered by many depositories and private label securitizations, and those seconds proved to be highly risky as well as a significant obstacle to effective loss mitigation.

In our view, the fundamentals of the traditional mortgage insurance model, if enhanced, form a good basis for developing a stronger system. We propose that primary (loan-level) mortgage insurance - subject to a high-quality regulatory regime – should result in capital relief for higher-LTV loans within each category, such that the presence of the insurance would drop the risk weighting to a lower LTV. Regulated entities should only be able to count mortgage insurance toward capital relief if it meets certain standards including, but not limited to:

- Strong minimum capital and reserving requirements, based on a robust stress-test model.
- Additional capital buffers before excess earnings can be distributed.
- Risk reserves based on original LTV ratios (not mark-to-market ratios).
- Bans on delegated underwriting, requirements that mortgage insurance companies confirm loan quality, and limits on claims denial.
- Limits on other allowable activities.

We are also concerned that the standards may unintentionally discourage depositories from participating in prudent high-LTV lending programs that benefit from state and local government support, either in the form of direct funding (such as forgivable and subsidized junior liens) or guarantees. Such programs have a track record of good performance, even throughout the foreclosure crisis, and banks should receive capital relief when participating in programs of this nature, which are subject to rules imposed by the program and monitored by the government entity sponsoring them.

2. ***Focus risk categories on the sustainability of the loan product (Question 5).***

Currently, the determinants for classifying mortgages as “Category 1” and “Category 2” focus largely on product-related features. We agree this product-based approach to classification is correct. The proposal correctly identifies the “the proliferation of high-risk mortgage products” as a primary cause of the foreclosure crisis and appropriately proposes higher capital weights for mortgage loans with “product features associated with higher credit risk.” For example, an analysis of 19.5 million loans originated from 2004-2008 found that simply excluding all loans not meeting proposed Qualified Mortgage product standards reduced total defaults by nearly half. [5]

We also agree that it is appropriate to deem all Qualified Mortgages as Category 1. However, we do not think that all mortgages outside the still-unknown Qualified Mortgage definition should necessarily be Category 2. The Qualified Mortgage definition will likely require borrower-based underwriting factors, and we do not see it as useful to link specific underwriting factors with capital standards.

Using underwriting standards to categorize mortgages for risk weighting purposes fails to recognize the difference between *flexible* underwriting and *inadequate* underwriting. The latter, which played a major role in triggering the crisis, will be dramatically curtailed by the ability-to-repay rule established under Dodd-Frank, which applies to the entire market. For example, the same analysis mentioned above found that applying further underwriting restrictions to the expected Qualified Mortgage definition would significantly constrain credit -- most acutely among low and moderate income borrowers and minority borrowers -- without commensurately reducing risk.

However, we are concerned about the significant difference in risk weights between Category 1 and Category 2. Potentially doubling the risk weights for carefully underwritten but non-standard loans could adversely impact lending to underserved borrowers and communities. We ask that you consider lowering the Category 2 risk weight of 200% if other indicia of sustainability are present.

3. ***Ensure that risk-weighting rules do not discourage lenders and investors from modifying troubled mortgages to reduce risk of default or re-default.***

The proposed rule correctly recognizes loan modifications as a critical component of any bank's risk management. Providing borrowers who have defaulted or are at risk of defaulting with affordable, sustainable loan modifications rather than foreclosing on them mitigates losses to investors, preserves neighborhood, and stabilizes home values.

The proposed rule is not entirely clear about what latitude banks have in terms of reclassifying loans that have been modified.[6] It appears that generally speaking, the rule intends for the loan to be reclassified and the LTV recalculated at the time of modification, except for modifications made under the Home Affordable Modification Program (HAMP). Because the vast majority of troubled loans have declined in value, in many cases to LTVs well over 100, and because many otherwise affordable and sustainable modifications contain features such as term extensions that would cause a loan to become a category 2 loan, reclassifying modifications could result in a higher risk weight for some loans. This could discourage banks from modifying the loan, a perverse result given that a good modification increases the likelihood of payment, thus reducing the risk of the loan.

Thus, in response to the question about whether other modifications should also be exempted from any action as HAMP modifications are, we believe they should be as long as they either lower monthly payments or reduce principal, because both of these actions have been demonstrated to reduce risk of re-default. (All loan modifications are not the same; for example, if an investor simply capitalizes arrearages and recasts the loan, making the monthly payment higher, the modification does little to help the struggling homeowner and may increase rather than decrease the risk of re-default.) This expansion of the exemption to other modification programs that reduce risk is essential: the HAMP program expires in December 2013, at which point most modifications will likely be proprietary.

In short, we believe that by agreeing to modify a loan in default in a manner that reduces monthly payments or principal balance, the lender or investor in no way adds to potential losses on that loan; rather, an affordable and sustainable modification would likely decrease the likelihood of default. Consequently, we recommend clarifying the rule to ensure that sustainable modifications never result in an increase to capital requirements.

4. *Distinguish between different types of second liens when setting risk weights.*

All second liens are automatically considered Category 2 loans under the proposed rule, and thus carry relatively high capital requirements. However, not all second liens are created equal. So-called “simultaneous seconds” or “piggyback loans,” which in many cases supplemented or replaced a down payment, were a hallmark of subprime lending, and they were more likely to be made as closed-end second mortgages (CES) rather than lines of credit. More conventional home equity lines of credit (HELOC) are typically taken out after the family has been in the home for some time and are used more like credit cards or other consumer loans to pay for college, start or expand a small business loans, or make necessary renovations to the home.

Data shows that piggyback second liens perform much worse than second liens taken out subsequent to the purchase, and that effect is more pronounced for CES than for HELOC liens.[7] What’s more, under the proposed rules, a small consumer loan carries only a 100% risk weight, whereas a loan secured by a home can carry up to a 200% risk weight depending on LTV.

We recommend that when setting the capital requirements on second liens, regulators: (1) differentiate between second liens originated at or close to the time of the origination of the first lien and less-risky “conventional” home equity lines of credit; and (2) ensure that HELOC risk weights are line with consumer loan risk weights.

5. *Expand the equity rules on multifamily loans to avoid disadvantaging loans that expand affordable housing.*

The proposed rule creates a new category of “High Volatility Commercial Real Estate” (HVCRE) loans that carry a 150% risk weight. HVCREs would be loans with an LTV of more than 80 for which the borrower contributed less than 15 percent of the real estate’s completed value in “cash or unencumbered marketable assets (or has paid development expenses out of pocket).” However, rather than using cash for down payments, the vast majority of subsidized, affordable, multifamily housing in the U.S. is financed with a combination of secured and unsecured debt, direct grants, and tax credits provided by the U.S. government to each state, and is subject to a legal commitment to serve low-income residents, with rent levels and operations regulated by government. [8] In other contexts, the developer may have donated land or a land conveyance from the seller at below market, which effectively acts as equity. If non-cash equity is not considered, this proposal regarding HVCREs could significantly hold back the affordable multifamily housing market in the U.S.

Tax credits and other forms of government capital provided to affordable housing projects (such as private equity capital) provide safety and soundness because public resources represent a capital investment by the provider in the success of the property. Occupancy of tax-credit-financed housing over the past decade is in excess of 96% [9] and this product has an extremely low default rate,[10] which demonstrates how public and private interests align to sustain these properties. Public entities and tax credit investors provide additional screening and monitoring functions that can help reduce risk. Moreover, since program rules tend to restrict how much equity is invested in these regulated properties, a conventional LTV calculation is not an adequate proxy for stability in these instances.

The demand for affordable multifamily housing dramatically exceeds the supply. According to the latest survey of the National Low Income Housing Coalition, there is a shortage of 6.8 million affordable apartments in the U.S.[11] Consequently, we request that the regulations treat tax credit equity and similar public capital and/or donated land invested in subsidized, affordable housing properties that are subject to a legal commitment to serve low-income residents with rent levels and operations regulated by government, as meeting the 15% equity threshold for the purposes of the HVCRE LTV calculation. This treatment will help provide a level playing field for affordable housing developers and avoid undermining a vital public resource.

6. ***Exempt small banks, community lenders, and Community Development Financial Institutions from changing their mortgage-related capital standards or at least do not require risk weights to be adjusted for existing mortgages.***

The proposed rule applies the same mortgage-related capital standards to all banks regardless of size. We are concerned that such a one-size-fits-all approach could unnecessarily restrain mortgage lending by critical financial institutions that did not meaningfully contribute to the crisis, namely small banks, community lenders, and Community Development Financial institutions that serve predominantly low-wealth borrowers.

Due to their size and scope, small banks and CDFIs tend to have a better understanding of the needs of their customers and offer mortgage products to fit that demographic. For example, they often are able to offer non-standard mortgage products that have proven to be sustainable when carefully underwritten and managed, such as those with low down-payments or flexible payment structures. The proposed rules would place unnecessarily high risk weights on these non-standard loans (particularly for Category 2 mortgages, as noted above), forcing small banks and community lenders to significantly scale back their business. As a result, it would be more difficult for them to provide this crucial source of lending for borrowers and communities often underserved by the bigger banks. What's more, the complexity of the rules poses a more onerous burden on these institutions.

Driving mortgages out of these smaller banks would be inconsistent with the intent behind the Basel III accords and the Dodd-Frank financial reform law. These small and community-focused institutions pose little systemic risk to the financial system and have a proven track record of safely and sustainably serving low- and moderate-income families. Capital rules should promote such sustainable lending, not cripple it.

For these reasons, we recommend exempting small banks and Community Development Financial Institutions from the new mortgage-related capital requirements and allow these institutions instead to continue operating under current rules.[12] If such an exemption is not provided, we recommend that institutions not be required to change the risk weights on existing loans.

Conclusion

We commend the work that has gone into crafting the proposed rules and generally support the higher capital standards in the risk-based capital levels. We encourage the regulatory agencies to ensure that the rules can also support access to affordable and sustainable mortgage products to creditworthy borrowers, appropriate loan modifications made to reduce risk, and the development of affordable rental housing.

If you have any questions about this comment, please contact Julia Gordon, Director of Housing Finance and Policy, Center for American Progress, at 202-478-5324 or jgordon@americanprogress.org. Again, thank you for the opportunity to provide our input.

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ENDNOTES

[1] Mortgage Bankers Association, "Impact of QRM," Presentation material, February 2012, available at http://www.mbaa.org/files/Advocacy/2012/RiskRetentionPresentation.pdf

[2] Center for Responsible Lending, "Don't Mandate Large Down Payments on Home Loans," Fact sheet, February 25, 2011, available at http://www.responsiblelending.org/mortgage-lending/policy-legislation/regulators/low-downpayment-factsheet-final.pdf

[3] Lei Ding, Roberto G. Quercia, Wei Li, and Janneke Ratcliffe, "Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Models," *Journal of Real Estate Research,* 33 (2) (2011): 245-27.

[4] Ibid.

[5] Quercia,Roberto, Lei Ding and Carolina Reid, Balancing Risk and Access, UNC Center for Community Capital. March 5, 2012. http://www.ccc.unc.edu/documents/QRM%20Underwriting.3.2012.pdf

[6] Accounting rules should make clear that write-downs need to occur when there are indicia of impairment.

[7] Donghoon Lee, Christopher Mayer, and Joseph Tracy, "A New Look at Second Liens," unpublished, available at http://www.nber.org/chapters/c12623.pdf

[8] Developers of affordable housing in the U.S. most typically secure equity through the Low Income Housing Tax Credit. The program is divided among the states based on respective populations. See Section 42 of the Internal Revenue Code, Authorized in 1986.

[9] Reznick Group, "The Low Income Housing Tax Credit Program at Year 25: A Current Look at Its Performance," (2011).

[10] Ibid. Reznick surveyed 16,399 Low Income Housing Tax Credit Properties. The foreclosure rate on this cohort was .62%.

[11] Elina Bravve, Megan Bolton, Linda Crouch, and Sheila Crowley, "Out of Reach 2012: America's Forgotten Housing Crisis," (Washington: National Low Income Housing Coalition, 2012).

[12] For more details, see the comment letter from the Community Development Bankers Association to the FRB, FDIC, and OCC dated September 10, 2012.