Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

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Summary of Mortgage-Related Provisions in Basel III*

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In August 2012, the Federal Reserve Board (Board), the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) published a joint proposed regulation to implement the Basel III Accord (applicable to internationally active banks[1]) and to make changes in the capital rules applicable to all banks and savings associations.[2] On July 2, 2013, the Board approved a final version of the new capital rule, and the Comptroller approved the same rule on July 9. The FDIC approved the rule in the form of an "interim final rule" on July 9, in order to provide an opportunity for public comment on the interaction with the new rule and proposals to increase the leverage ratio for very large bank holding companies and their subsidiary banking institutions.

I. Risk-weight for Mortgages

The new rule is very similar to current rules, with one difference. Under the Basel III rule, first mortgages will be assigned a 50 percent risk-weight if the collateral is either owner-occupied or rented, the loan is not 90 days or more past due or carried in non-accrual status, and the loan is not restructured or modified (other than through the Treasury's HAMP program). The loan must be prudently underwritten, including in accordance with LTV standards.[3]

*The information contained in this newsletter does not constitute legal advice. This newsletter is intended for educational and informational purposes only.

[1]An internationally active bank is defined as a banking organization with $250 billion or more in consolidated assets or on-balance sheet foreign exposures of $10 billion or more.

[2]77 Fed. Reg. 52792 (Aug. 30, 2012).

[3]Interagency supervisory standards require that first mortgages on owner-occupied property that have an LTV of 90 percent or more must have credit enhancement in the form of mortgage insurance or readily marketable collateral. See, e.g., 12 CFR part 34, App. A, "Supervisory Loan-to-Value Limits."

One difference between the two versions of the capital treatment of mortgage loans is that the current rule contains a presumption that a first mortgage is collateralized by an owner-occupied or rented residence, and is not 90 days or more past due or carried in non-accrual status, will be presumed to have been prudently underwritten. The new rule does not include this presumption.

II. Mortgage Servicing Rights

Mortgage servicing rights may not exceed 10 percent of a bank's common equity Tier 1 elements. Thus, to the extent a bank holds mortgage servicing rights that exceed this 10 percent threshold, the excess amount must be deducted from the common equity Tier 1 account. In addition, mortgage servicing rights, together with deferred tax assets, and investments in the capital of unconsolidated financial institutions and subsidiaries, cannot exceed 17.65 percent of the bank's common equity Tier 1 capital elements.

To the extent that mortgage servicing rights are not required to be deduced from capital, they will be risk-weighted at 250 percent.

III. Pre-Sold Construction Loans

The Basel III rule is essentially the same as the current regulation: presold 1-4 family residential construction loans may be risk-weighted at 50 percent if specified conditions are met. These conditions include: (i) the builder must incur at least the first 10 percent of the direct costs of the land, labor and materials; (ii) the loan may not exceed 80 percent of the sales price of the presold home; and (iii) the purchaser must have put down at least a 3 percent non-refundable earnest money deposit.

IV. Commercial Real Estate

The existing rule assigns a 100 percent risk-weight to acquisition, development and construction loans ("high volatility commercial real estate"). The

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proposed regulation would increase the risk-weight for these assets to 150 percent, *unless* the loan facility is financing:

(1) a 1-4 family residential property development;

(2) the purchase of real property that qualifies as an investment in community development (subject to certain restrictions);

(3) the purchase or development of agricultural land, provided the value of the property is based on its agricultural use and not it's potential for development; and

(4) commercial real estate projects, provided certain LTV ratios are met and the borrower has contributed prescribed amounts of capital in the form of cash or unencumbered readily marketable assets prior to any draw on the facility.

V. Un-extended Home Equity Lines of Credit

Under current rules, the undrawn amount of a home equity line of credit has a 0 percent conversion factor[4] if the line of credit has an original maturity of one year or less. Undrawn home equity loans of any duration also have a 0 percent conversion factor if they are unconditionally cancelable by the lender at any time. All other undrawn home equity lines of credit are converted to a balance sheet item using a 50 percent conversion factor.

Under the new rule, undrawn lines of credit that are unconditionally cancelable by the bank will retain the 0 percent risk-weight. Home equity lines of credit that are not cancelable will be converted to on-balance sheet assets using a 20 percent conversion factor if they have an original maturity of one year or less. All other home equity lines of credit will have a 50 percent conversion factor.

[4]Undrawn lines are off-balance sheet items. The conversion factor is used to convert these items to on-balance sheet equivalents for capital purposes. After they are so converted, they are risk-weighted based on the characteristics of the item. Thus, the percentage of the HELOC that is converted to an on-balance sheet equivalent could be risk-weighted at 50 percent if it is the first lien on the property and meets the other conditions for that risk-weight, and would be risk-weighted at 100 percent if it is secured by a junior lien.

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Undrawn HELOC Lines

Undrawn HELOC	Existing Conversion Factor	Basel III Conversion Factor
Unconditionally Cancelable	0%	0%
Maturity of one year or less	0%	20%
All other HELOC	50%	50%

VI. Repurchase Agreements, Security Lending, Representations and Warranties and Similar Items

Under the Basel III rule, a bank must recognize, and hold capital against, off-balance sheet obligations created by repurchase agreements, credit-enhancing representations and warranties, securities lending and borrowing transactions, financial standby letters of credit, forward agreements, and other similar exposures. The off-balance sheet component of a repurchase agreement is the value of the assets the bank has sold, subject to the bank's contractual obligation to repurchase at a later date. The off-balance sheet component of a securities lending transaction is the value of the securities lent under the transaction. For securities borrowing transactions, the off-balance sheet item is the value of non-cash collateral the bank has posted in order to borrow the securities. These items are converted to on-balance sheet exposures using a 100 percent conversion factor.

VII. Over-the-Counter Derivative Contracts

Financial institutions holding interest rate sensitive assets, engage in derivative transactions to protect against swings in prevailing interest rates. This includes mortgage-backed securities transactions conducted in the "to be announced" market.

The new rule requires banking organizations to hold capital with respect to such derivative agreements, with the amount of the capital charge dependent upon the counterparty, the collateral, and the remaining maturity on the contract. The proposal would allow for lower capital charges with re-

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spect to derivative contracts and repurchase agreements that are cleared through a central clearinghouse.

VIII. Securitization Positions

Under current rules, investments in private label mortgage-backed securities are based on the credit rating of the security. The Basel III rule does away with reliance on credit ratings, and instead requires the investing bank to undertake due diligence of the credit risks involved, to the satisfaction of the primary regulator. The due diligence must include an analysis of the structural features of the securitization such as the cash flow waterfall, triggers, credit enhancements, and the specific definitions of default used in the securitization. The bank must also consider relevant information about the performance of the underlying securities, market data, and price volatility, trading volume, and size, depth and concentration level of the market for the securitization. Investments in Fannie Mae and Freddie Mac mortgage-backed pass through securities are automatically assigned to the 20 percent risk-weight. Federal Home Loan Bank securities are also assigned a 20 percent risk-weight.

The new rule requires a 100 percent risk-weight for interest only mortgage-backed securities.

IX. Accumulated Other Comprehensive Income (AOCI)

Current rules provide that unrecognized gains and losses on securities held in portfolio as "available for sale" do not affect regulatory capital, but instead are accounted for as "Accumulated Other Comprehensive Income" (AOCI). The new rule provides that all changes in AOCI must be reflected in the bank's regulatory capital, but permits smaller banking organizations (those not subject to the advanced approaches requirements) to make a one-time election not to use this new rule, and instead continue to use existing rules regarding available for sale securities. This is called the "AOCI opt-out election."

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X. Effective Date and Excluded Savings and Loan Holding Companies

For banking organizations that are subject to the advanced approaches ($250 billion or more in consolidated assets and $10 billion or more in foreign exposures), compliance with the new rule begins on January 1, 2014. For smaller banking organizations, compliance begins on January 1, 2015. For all banking organizations, longer transition periods are specified with respect to reaching enhanced minimum capital levels and making newly required deductions from capital.

Savings and loan holding companies that are primarily engaged in non-financial activities (50 percent or more of assets or revenues) and savings and loan holding companies that are substantially engaged in insurance activities are excluded from these regulatory capital rules, pending the implementation of a new capital framework to cover these companies in the future.

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