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

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Mortgage Finance Under Basel III*

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The Basel Committee

The Basel Committee on Banking Supervision is an informal organization consisting of the chief banking regulatory authorities and central banks from the world's leading economic countries. It began meeting in Basel, Switzerland at the end of 1974, focusing on bank supervisory issues common to its member countries. In the 1980s, the Basel Committee recognized that existing bank capital standards had two significant deficiencies. First, they were not uniform among member countries, thus providing competitive advantages to banking organizations that had lower minimum capital requirements. Second, to the extent that banks were subject to standards, they did not differentiate based on the riskiness of the bank's portfolio. Under existing capital rules, a bank investing in relatively safe assets (e.g., Treasury bonds) would have the same capital requirement as a bank investing in unsecured debt.

In 1988, the Basel Committee reached an agreement on a new capital framework (Basel I) intended to address these two concerns. A minimum capital requirement of 8 percent was established in all member countries. In order to increase risk sensitivity, bank assets were originally divided into various broad categories, with a risk weight assigned to each category. The amount of capital required is based on the risk weight. For example, commercial loans are risk weighted at 100 percent risk, residential mortgages at 50 percent, GSE backed securities at 20 percent, and Government obligations are given a zero percent weight.

In June 1999, the Basel Committee determined that a more refined system was needed in order to align more precisely capital and risk. This new system, called Basel II, was agreed to in 2004. The Basel II framework, as agreed to internationally, permits organizations to use three methods for

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determining minimum capital. However, in the United States, only the most advanced approach was approved for use. Under this approach, minimum capital is determined by using statistical analysis in order to determine the probability that any particular loan or other asset will default, and the amount of loss that the bank will likely incur as a result of such a default.

Before the Basel II framework was actually used by any U.S. banking institutions, the financial crisis hit, and the Basel Committee determined that refinements were needed. In December 2010, the Committee released the text of a new capital framework, Basel III. As a general matter, Basel III is intended to significantly raise minimum capital requirements by more fully taking into account the stresses that can arise during a market-wide panic, as well as to strengthen the entire financial system more generally.

Basel III and Mortgage Finance

Implementation of the Basel III framework in the United States requires the three Federal banking agencies to issue legally binding rules. In June of this year, these agencies began that process by releasing three proposed regulations to apply the Basel III framework to banks and bank holding companies. Under these proposals, both community and regional banking organizations, as well as the very largest international banking companies, will be required to adopt new capital standards and methods. In the area of mortgage finance, the new rules will significantly increase the capital requirements for mortgages, and thus likely have a restraining impact on the recovery of the housing market. It is important to understand how these rules will affect mortgage lending, and to analyze whether the current underwriting standards used in making mortgages warrant the additional capital charges. We will provide three examples of how the proposed rule will increase the capital needed for home finance.

A. Risk Weight for Residential Mortgages Held in Portfolio

Under current regulations, prudently underwritten residential mortgages are assigned a risk weight of 50 percent, meaning that a bank only has to hold one-half the capital for a mortgage as for a commercial loan.

Under the proposal, mortgages are divided into two categories, and then subdivided based on the loan-to-value ratio (LTV). Private mortgage insurance does not count when determining LTV. Therefore, a first time home buyer with a 5 percent cash down payment that obtains mortgage insurance

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for 20 percent of the loan will be considered as having a 95 percent LTV for capital purposes.

Category 1 mortgages have lower capital charges than Category 2 loans. In order to be a Category 1 loan, the mortgage must meet the following requirements:

- It must be a first mortgage;
- The term may not exceed more than 30 years;
- The loan cannot have a balloon payment;
- The loan may not have a negative amortization feature;
- The loan cannot allow for the deferment of principal payments;
- Underwritten by taking into account all of the borrower's obligations, including taxes, insurance and assessments;
- Income information used to underwrite the loan is documented and verified;
- Creditor must have made a reasonable determination that the borrower can repay the loan using the maximum allowable interest rate in the first five years; and
- If an ARM, the amount of interest rate increase is capped at 2 percent per year, and no more than 6 percent over the life of the loan.

Category 2 includes all mortgage loans that are not Category 1 loans, including second liens and Home Equity Loans that are junior to a first mortgage.

The risk weight is then found by looking at the LTV. For Category 1 loans, the following risk weights apply:

LTV	**Risk Weight**
Equal to or less than 60 percent	35 percent
Greater than 60 percent but equal to or less than 80 percent	50 percent
Greater than 80 percent but equal to or less than 90 percent	75 percent
Greater than 90 percent	100 percent

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For Category 2 loans, the capital charges are significantly higher. For example, a mortgage with an LTV of 90 percent or more would have a 200 percent risk weight, and a loan with an LTV between 80 and 90 percent would have a risk weight of 150 percent.

B. Mortgage Servicing Rights

Mortgage servicing refers to activities related to collection of loan payments, sending notices, arranging for escrow to be held, paying taxes and insurance from the escrow, and in the event of a default, taking the necessary steps to cure the default or foreclose. The right to conduct and to be paid for these activities is known as "mortgage servicing rights," and they may be retained by the original lender or sold to a third party. The proposed regulation provides that the value of mortgage servicing rights that exceeds 10 percent of a bank's common equity must be deducted from capital. To the extent that mortgage servicing rights are not deducted from capital, they would be risk weighted at 250 percent.

C. Un-extended Home Equity Lines of Credit

The proposed regulation would essentially double the capital required to be held against undrawn home equity lines of credit, unless the bank retains the right to cancel the line at any time.

D. Securitization Positions

Under current rules, investments in private label mortgage-backed securities are based on the credit rating of the security. The proposal does away with reliance on credit ratings, and instead will require 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, 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. Except for GSE-backed securities, this proposed rule will add significant regulatory burden on banking institutions seeking to purchase private label mortgage-backed securities, thereby depressing the market for

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these securities.

Conclusion

The goals of the Basel Committee are important and if achieved, will provide a healthier and more robust financial system. However, in light of the very high mortgage underwriting standards that are currently required, and the new non-capital rules that will soon be issued by other regulatory bodies under the Dodd-Frank Act, the additional capital requirements proposed under Basel III may be both unnecessary and counter-productive to our economic recovery. Basel III is premised, in large part, on relating capital requirements to actual risk. An important issue that the banking agencies need to address before issuing a final rule is whether the actual risk in mortgage lending, now and in the foreseeable future, justify the proposed increases in capital for home loans.

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