Statement of the
NATIONAL ASSOCIATION of REALTORS®
on
Basel II: Capital Changes in the U.S. Banking System
and the Results of the Impact Study

For Submission to the
Subcommittee on Financial Institutions and Consumer Credit
and the
Subcommittee on Domestic and International Monetary Policy,
Trade and Technology
of the
House Financial Services Committee

May 11, 2005

Introduction

The National Association of Realtors® ("NAR") is pleased to submit this Statement for the Record to the above House Financial Services Subcommittees on the Basel II Capital Accord ("the Accord"). We appreciate the time and effort that its members, including Committee Chairman Michael Oxley and Subcommittee Chairs Spencer Bachus and Deborah Pryce, have spent on this very important issue, and we look forward to working with you to address the concerns that we have with the Accord.

NAR is the nation's largest professional trade association with almost 1.2 million members who belong to over 1,500 REALTOR® associations and boards at the state and local levels, as well as various institutes, societies and councils designed to enhance their expertise in real estate. NAR's members include brokers, salespeople, property managers, appraisers and counselors, as well as others engaged in all aspects of the real estate industry.

Our Position

NAR supports the overall goal of the Accord; however, we believe that the Accord should not skew lending away from real estate and are concerned that:

- Its potential effect on the real estate industry is not yet clear.
- Its treatment of high volatility commercial real estate ("HVCRE") loans could unnecessarily slow down that segment of the industry.
- Its treatment of commercial real estate does not adequately capture loans on properties that have partial equity or are partially pre-leased or pre-sold.

As a result, we support the *United States Financial Policy Committee for Fair Capital Standards Act of 2005* (H.R. 1226) that would create an interagency committee of federal financial regulators to study and report on the Accord's potential impact on the economy, including the real estate industry.

Real Estate is an Important Part of our Economy

The federal regulators that comprise the Financial Policy Committee – the Federal Reserve Board, Office of the Comptroller of the Currency, Office of Thrift Supervision, and Federal Deposit Insurance Corporation – should make sure that the Accord does not directly, or indirectly, harm our nation's real estate market or the hundreds of thousands of associated real estate professionals.

NAR is concerned that changing the reserve requirements of certain types of lending may create an incentive for banks to direct their lending away from real estate, and thereby potentially slow or dampen the flow of credit to this vital economic sector.

The real estate industry is one of the driving forces of our national and local economies, as it contributes significantly to homeownership, employment, development, retail sales and tax revenues. Commercial real estate, in particular, has proven to be fundamentally strong and has helped our nation recover from several recent negative events, including the downturn in the technology sector, stock market declines, accounting scandals and the September 11 terrorist attacks.

The New Accord Would Take Effect in 2008

In 1998, the Switzerland-based Bank for International Settlements decided to revise its 1988 Basel I Capital Accord to better reflect underlying economic risks and create a more stabilized international banking system. The new Accord is being developed by top central banking officials of the Group of 10 (G-10) nations, and would be fully effective in January 2008.

The largest U.S.-based, internationally-active banks would have to comply with the new standards of the Accord. Other banks could voluntarily "opt in" if federal regulators approve their risk management measures; however, only a few are expected to do so due to high compliance costs. Banks not subject to the new Accord would remain subject to the capital standards of the original Basil I agreement (which federal regulators plan to update as well).

The Accord contains three main components, or "pillars." Pillar 1 establishes minimum capital reserve requirements (based on complicated formulas relating to both credit and operational risks) to protect against potential losses; Pillar 2 creates an enhanced review process of an institution's loan policies and capital reserves; while Pillar 3 imposes improved public disclosure requirements.

The Overall Effects of the Accord Need to be Better Understood

Preliminary analyses of the most recent Quantitative Impact Study (QIS4) show that banks with similar assets and risk profiles would have widely different capital requirements under the Accord. For example, some banks have estimated that their overall capital requirements (for all types of loans) would drop between 20 and 40 percent, while others have estimated they would actually increase by up to 60 percent. Capital requirements for specific types of loans (commercial and non-commercial) could vary even more dramatically.

As a result of this unexpected and unsettling data, federal regulators decided to postpone their Notice of Proposed Rulemaking so they could have more time to evaluate QIS4. NAR supports this decision and believes that the Accord should not be implemented in the United States until it has been thoroughly examined and modified to eliminate potential disruptions to the commercial real estate market and the broader economy.

The Accord Could Hinder Certain Types of Commercial Real Estate

NAR is concerned that the Accord could have unintended and undesirable consequences for the commercial real estate industry. Pillar 1 would appear to increase the capital reserve requirements for certain real estate loans, specifically those relating to HVCRE – properties that are purchased for acquisition, development and construction (ADC) and do not have "substantial equity" or are not "sufficiently pre-leased."

As a result, banks would have less incentive to make HVCRE loans because more capital reserves would have to be put aside to cover potential losses. To the extent banks decide to make such loans, they would probably charge higher interest rates to offset their higher reserve requirements, which in turn would create a disincentive for investors and developers to acquire HVCRE property. Funds that would otherwise go to HVCRE loans would most likely be redirected to other types of loans that have lower reserve requirements, including those relating to income-producing real estate (IPRE), non-commercial real estate and corporate bonds

In addition, the terms “substantial equity” and “sufficiently pre-leased” should be better defined so partially-sold or partially-leased ADC properties can be clearly classified as HVCRE, IPRE or a newly-created category.

The Accord Would Revise the Risk Formula for HVCRE Loans

The Accord would restructure the formulas that banks use to determine default risks for certain classes of real estate, including HVCRE. It would incorporate asset correlation variables that are designed to measure the likelihood that a particular default(s) would trigger a broader downturn in that asset class or industry sector.

For example, properties specifically geared towards one particular industry or use (e.g., resort hotels) would be more susceptible to market fluctuations in that industry. Under the Accord, these types of properties would have a higher asset correlation value (and considered riskier) than properties that have multiple uses or can be leased to various types of tenants (e.g., retail stores).

Absent evidence that existing HVCRE loans do not adequately account for market susceptibilities, these loans should not be treated differently under the Accord than they are now. Underwriting standards and appraisal procedures for HVCRE loans have improved dramatically over the past decade, and many of them are securitized (allowing for greater transparency, liquidity and scrutiny by federal agencies). Securitized vehicles include commercial mortgage backed securities (CMBS), real estate investment trusts (REITs) and real estate mortgage investment conduits (REMICs).

HVCRE has played an important role in the growth of commercial development across our country; therefore, related loans should not be discouraged through the revision of risk formulas.

Legislation Would Create an Interagency Committee to Review the Accord

NAR supports legislation recently introduced by Chairman Spencer Bachus – the *United States Financial Policy Committee for Fair Capital Standards Act* (H.R. 1226) – that would create an interagency committee (consisting of the federal banking regulators and the Secretary of the Treasury) assigned to develop uniform positions on the Accord’s provisions and report to Congress before it could be implemented in the United States. This bill also would require the Committee to evaluate the effects the Accord would have various sectors of the economy, including the real estate industry. If the members of the Committee cannot agree on an issue, the Secretary of the Treasury would decide.

H.R. 1226 should be enacted as soon as possible so federal regulators can collectively review the Accord, determine its potential adverse effects to the commercial real estate industry and modify relevant provisions prior to its implementation. NAR and its members look forward to working with the Financial Services Committee and its Subcommittees to advance this legislation in both the House and Senate.

Conclusion

Commercial real estate has been a stable and important component of our economy and

should not be harmed or weakened by the Accord. Therefore, NAR supports H.R. 1226 and encourages Congress and federal regulators to ensure that certain types of commercial property would not be negatively affected.

We appreciate this opportunity to express our views on this very important matter.

Copyright NATIONAL ASSOCIATION OF REALTORS®
Headquarters: 430 North Michigan Avenue, Chicago, IL. 60611-4087
DC Office: 500 New Jersey Avenue, NW, Washington, DC 20001-2020
1-800-874-6500