NATIONAL ASSOCIATION OF REALTORS®

The Voice For Real Estate®

500 New Jersey Avenue, N.W.
Washington, DC 20001-2020
202.383.1194 Fax 202.383.7580
www.realtors.org/governmentaffairs

Thomas M. Stevens, CRB, CRS, GRI
President

Dale A. Stinton, CAE, CPA, CMA, RCE
EVP/CEO

GOVERNMENT AFFAIRS
Jerry Giovaniello, Senior Vice President
Walter J. Witek, Jr., Vice President

NATIONAL ASSOCIATION OF REALTORS®'

Statement on:

"An Update on the New Basel Accords"

For Submission to the

Senate Banking Committee

September 26, 2006

Introduction

The National Association of REALTORS® (NAR) is pleased to submit this Statement for the Record to the Senate Banking Committee in connection with its hearing on the Basel Accords. We also would like to take this opportunity to provide you with our comments on the Proposed Commercial Real Estate Lending Guidance put forward by the financial regulators. We appreciate the time and effort that its members, including Committee Chairman Shelby and Ranking Member Sarbanes, have spent on this very important issue, and we look forward to working with you to address the concerns we have with the Basel Accords and the proposed guidance on commercial real estate lending.

The National Association of REALTORS®, "The Voice for Real Estate," with over 1.3 million members, is America's largest trade association, including NAR's five commercial real estate institutes and its societies and councils. REALTORS® are involved in all aspects of the residential and commercial real estate industries and belong to one or more of some 1,500 local associations or boards, and 54 state and territory associations of REALTORS®. NAR is concerned that the combined effects of the Basel Accords with the proposed guidance on commercial real estate lending could unnecessarily reduce the flow of capital to commercial real estate and hurt commercial real estate markets. Because the proposed regulations appear to tighten capital requirements more than appropriate considering the risk profile of commercial loans, NAR asks that the subcommittee to help ensure that the proposed commercial real estate lending guidance and Basel I-A requirements are revised to ensure that the flow of capital to commercial real estate is not diminished.

REALTOR® is a registered collective membership mark which may be used only by
real estate professionals who are members of the NATIONAL ASSOCIATION OF REALTORS®
and subscribe to its strict Code of Ethics.

The commercial real estate market is robust and enjoys a stable outlook. According to NAR's Commercial Real Estate Outlook of September 12, 2006, large institutions are increasing their investment in commercial real estate. Institutions (such as life insurance companies, pension funds, and life insurance companies) are generally risk averse and base their investment decisions less on the fluctuations of interest rates, and more on the overall health and stability of the commercial real estate market. During the first eight months of 2006, institutional investors and private equity funds accounted for over one half of office building sales volume, and one third of industrial property sales[1]. The increase in investment in commercial real estate from institutional investors demonstrates that a market downturn similar to that of the late 1980's and early 1990's is highly unlikely.

NAR's most recent Commercial Real Estate Outlook also notes that the increase of energy and construction costs have prompted a slowdown in the development of speculative real estate. This means that for the foreseeable future, commercial real estate will remain a landlords' market and that vacancy rates should remain historically low. Furthermore, as noted in our detailed comments on Basel IA below, both the FDIC and the Federal Reserve have noted in the past year that the risk management practices and the underwriting procedures of most financial institutions have improved significantly since the early 1990s.

Despite the strong overall long-term outlook for the commercial real estate markets, the financial regulators have issued proposed guidance on commercial real estate lending that takes a broad brush approach to rein in banks that have relatively high concentrations of commercial real estate loans, and through an advance notice of proposed rulemaking for Basel I-A have implied an intention to revise Basel I in ways that, in effect, would increase the risk weighting for commercial real estate from where it is now and as compared to what is being proposed under Basel II. We do not understand the basis for that result.

NAR favors the establishment of commercial real estate risk management guidelines that preserve and strengthen the safety and soundness of the banking system while not unduly harming the flow of capital to commercial real estate. At the same time, NAR also recommends the recalibration of Basel I-A to make it more responsive to the nuances of the commercial real estate marketplace. In both the proposed guidance on commercial real estate lending and the Basel I-A accords, NAR recommends that the regulators consider the performance characteristics of different classes of commercial real estate, noting that the performance in one sector is not necessarily related to that in another.

Summary of NAR Concerns:

Proposed Guidance on Concentrations in Commercial Real Estate Lending:

On January 13th, the federal regulators (Fed, FDIC, OCC, OTS) issued a proposed guidance on commercial real estate lending targeted to banks that have high concentrations in commercial real estate loans. The goal, ostensibly, is to mitigate against the potential economic fallout if the

[1] NAR Commercial Real Estate Outlook, September 2006.

commercial real estate market significantly slows. The guidance recommends enhanced risk management practices, that if implemented could potentially harm the flow of capital to commercial real estate. In NAR's letter comment letter to the financial regulators (attached), we expressed concern that the "impact of overly restrictive risk management practices that does not fully recognize the unique character of commercial real estate lending could increase the cost of capital and dissuade financial institutions from making loans to sound commercial real estate ventures.

NAR's recommendations:

- Recognize that different classes of commercial real estate lending have different performance characteristics. Not all commercial real estate exposures are the same.
- Financial institutions should be able to effectively manage risk through creating CRE portfolios that are diverse in exposures to different classes of commercial real estate in different regional markets.
- Failure to recognize distinctions in classes of commercial real estate could have the unintended consequence of driving property values in all classes of commercial real estate down, due an increase in the cost of capital.

Basel I-A:

The Basel Accords determine the process by which banks determine that capital they must hold in reserve to meet regulatory requirements. The Basel II accords apply to the 10 largest banks, while the Basel I accords apply to the smaller banks. The regulators began revising the Basel I accords to even out the competitive advantages that some perceive that Basel II gives to the larger banks. The accords develop a series of risk weights that attempts to account for the credit of the borrower against the risk certain lending classes pose. In October 2005, the financial regulators published an advanced notice of proposed rulemaking that proposes changes to the capital requirements of real estate loans. NAR commented that the proposed rules were an important first step in equalizing the inequalities between Basel II and BaselI.

NAR's recommendations:

- **Residential:** The proposed risk weights for residential (1 to 4 family) first lien mortgages are too high (at 35% for loans with 70%-80% loan to value ratios) and would put the smaller Basel I banks at a disadvantage to the larger Basel II banks which have a lower risk weighting for these types of loans. For example under Basel II the capital charge for these loans is 29 basis points, for Basel I banks it is 140 basis points. NAR recommends a risk weight for loans with an LTV under 70% at 10%, and a risk weight for loans with an LTV between 70% and 80% at 20%.
- **Private Mortgage Insurance (PMI):** The risk weighting for residential mortgages should reflect the protections that PMI provides.
- **Multifamily Residential Mortgages:** NAR recommends more favorable treatment for loans to commercial property that have a history of high occupancy levels.

- **Commercial Real Estate:** The Basel I ANPR (advanced notice of proposed rulemaking) moves commercial real estate loans to a higher than 100% risk weight, unless the loans satisfy prudential lending guidelines and the loan is supported by substantial equity (i.e. more than 15% of the completion value). NAR recommends that Basel I-A emulate the commercial real estate categories in Basel II -- Income Producing Real Estate (IPRE -- which includes office, hotel etc) with a risk weight of 50%, and 100% risk weighting to high volatility commercial real estate (HVCRE -- such as loans to speculative development and properties with specialized uses.)

Below are NAR's detailed analyses of both the Basel IA ANPR and the Proposed Guidance on Commercial Real Estate Lending which further underscores the need to set more appropriate guidelines and risk weights.

Basel I-A: *NAR urges regulators to consider protections of Private Mortgage Insurance, and the different real estate classes within commercial real estate.*

Background:

Under current regulations, banking and thrift institutions (banking organizations) are subject to a risk-based capital standard that is based on an international understanding reached by the banking regulators and central bankers of the leading economically developed countries in Basel, Switzerland, in 1988. This accord is commonly referred to as the Basel I capital framework, and it was implemented in this country beginning in 1989. Under the framework, the assets of banking organizations are assigned various "risk weights" based upon the relative credit risk of the asset, as determined by the regulatory agencies. Under the current standard, prudently underwritten mortgage loans are assigned to the 50 percent risk weight basket, and commercial real estate loans are assigned to the 100 percent risk weight basket.

More recently, the international and U.S. banking regulators and central bankers determined that the Basel I framework is in need of improvement. They believe that the current system does not accurately reflect the true economic risk of the various credits booked by banking organizations. Thus a mismatch exists between the true economic risk and the capital requirement imposed by the banking agencies. Further, the existing standard does not recognize many of the techniques a banking organization may use to mitigate risk, and therefore does not provide an incentive to take these measures.[2]

In recognition of these and other shortcomings, the international regulators developed a new capital framework, referred to as Basel II that will more closely align capital and risk. However, in the U.S. only a relatively handful of the largest banking organizations will be subject to this new framework due to the complexity of the standard and the need for each institution to utilize

[2] See, e.g. FDIC Staff Study, "Basel and the Evolution of Capital Regulation" (January 14, 2003).

costly and very sophisticated information management systems to comply with the requirements of the new framework.[3]

As a result, concerns have been raised that the banks subject to the new capital framework may gain a competitive advantage with respect to institutions subject the Basel I standards.[4] This concern is especially relevant in the area of home mortgage lending, where the capital requirement is predicted to be dramatically less for Basel II institutions.[5] As explained by one prominent banking trade association, the lower capital will most likely result in a cost advantage, and correspondingly a pricing advantage, in retail credits for Basel II banks. If community and other non-Basel II banks and thrift institutions are subjected to unfair competition from the largest banks, their ability to provide financial services to their communities and their profitability will suffer. The inevitable result will be further consolidation within the banking industry, resulting in an undesirable loss of locally focused institutions.[6] These smaller institutions are locally owned and run, and have expertise and detailed knowledge about their towns and communities that is not possible for larger national and regional organizations. The loss of these smaller institutions would result in an incalculable loss to the economy and vitality of our nation's heartland and the small business community nationwide.

Similarly, it is also important that, within the Basel I-A universe of depository institutions, the capital requirements be based on the relative risk of various activities so, for example, a thrift that makes real estate lending the primary focus of its business plan is not unfairly disadvantaged compared to larger lenders with other business plans.

The ANPR issued by the Federal banking agencies on October 20, 2005, is the agencies' attempt to deal with these concerns by making adjustments in the Basel I standard so that it is more risk sensitive, but without the regulatory burdens that will be required under Basel II. In so doing, the ANPR also seeks to address the competitive issues that are of great concern to the NAR, by

---

[3] Joint Federal Banking Agency Press Release, "Agencies Announce Publication of Revised Capital Framework and Describe U.S. Implementation Efforts" (June 26, 2004).

[4] See, e.g. Statement of Acting Comptroller Julie Williams, Before the Subcommittee on Financial Institutions and Consumer Credit of the House Comm. on Financial Services (May 11,2005) "(T)he OCC and the other agencies have focused considerable effort and attention on the potential competitive effects of the Basel II framework on the U.S. financial services industry.... (W)e are concerned that Basel II may create or exacerbate relative advantages between large domestic banks and mid-size/small domestic banks...(I)t is imperative that the U.S. agencies remain sensitive to these concerns...."

[5] Based on a survey of banking organization subject to Basel II, the capital requirements for residential mortgage loans will decline, on average, 62 percent, and the capital requirement for home equity lines of credit will decline, on average, by 74 percent, from the capital required for non-Basel II institutions. See, Statement of Richard Riccobono, Acting Director, Office of Thrift Supervision, before the Subcommittee on Financial Institutions and Consumer Credit of the House Comm. on Financial Services (May 11, 2005).

[6] Statement of the Independent Community Bankers of America, before the Subcommittee on Financial Institutions and Consumer Credit of the House Comm. on Financial Services (May 11, 2005). This concern was also raised by the trade association representing savings associations. See, Statement of America's Community Bankers, before the Subcommittee on Financial Institutions and Consumer Credit of the House Comm. on Financial Services (May 11,2005).

mitigating some of the disparity in capital requirements between Basel II and non-Basel II institutions.

In this regard, the ANPR makes a number of very positive suggestions that will help alleviate many of the concerns we have about the Basel II standards. We appreciate the agencies' concerns in this regard, and believe that the Basel I-A proposal is a positive step. However, we also believe that there is room for some improvement. We are therefore offering the following suggested changes with respect to the treatment of both residential and commercial real estate loans and lines of credit.

Recommendations:

1. One-to-Four Family Mortgages

Under current regulations, most one-to-four family first mortgages are eligible for a 50 percent risk weight. The ANPR states that this "one size fits all" approach does not adequately assess the credit risks posed by such loans. Instead, the ANPR proposes to assign a risk-weight to first lien one-to-four family mortgage loans after taking into account other factors, such as the loan-to-value (LTV) ratio of the loan, the credit-worthiness of the borrower (determined by a credit rating such as a FICO score), debt-to-income ratio, or some other measure of credit quality. These mortgages would then be assigned a risk weight basket of between 20 and 100 percent.

More specifically, the joint ANPR proposes that first lien one-to-four family mortgage liens with an LTV ratio of 70 percent or less be placed in the 20 percent risk weight basket, and mortgage loans with an LTV above 70 percent and up to 80 percent be placed in the 35 percent risk weight basket. We believe that in light of the very low credit risk posed by first lien residential mortgage loans the risk weights suggested in the joint ANPR are too high. Similarly, in light of the favorable capital charge that would be imposed on these loans under Basel II, the weight baskets suggested in the joint ANPR would not adequately deal with the competitive advantages Basel II provides to larger mortgage lenders.

There is no question that prudently underwritten first lien residential mortgage loans have historically low loss rates. According to Federal Reserve Board data, the average charge-off rate for these loans from 1991 through the 3rd quarter of 2005 was 0.15 percent.[7] As a result, the Tier 1 capital charge for these loans under Basel II is predicted to be as low as 12 basis points for well-qualified borrowers.[8] Under the joint ANPR, this same loan would result in a Tier 1 capital charge of 80 basis points, assuming the loan qualifies for the 20 percent basket as proposed in the joint ANPR.

---

[7] Board of Governors of the Federal Reserve System, Charge-Off and Delinquency Rates, Not Seasonally Adjusted. (Dec. 2005).

[8] Calem and Follain, "Proposed Competitive Impacts of Basel II in the U.S. market for Residential Mortgages," statement before the House Subcommittee on Financial Institutions and Consumer Credit 35 (May 11, 2005). According to this study, under Basel II, the capital charge for a first lien mortgage loan to a borrower with a FICO credit score 740 and with an LTV of 70 percent could be as low as 12 basis points.

Under Basel II, if the same well-qualified borrower took out an 80 percent LTV mortgage loan, the Tier 1 capital charge would be 29 basis points. But under the joint ANPR, the capital charge for the non-Basel II bank would be 143 basis points, assuming the loan qualifies for the 35 percent basket as proposed in the joint ANPR.

Thus, the reduction in capital suggested in the joint ANPR would still leave a wide gap in the treatment of mortgage loans with equivalent risks. This large difference will create competitive inequalities between mortgage lenders and could easily lead to further consolidation in the mortgage lending industry. We therefore recommend a risk-weight basket of 10 percent for prime first lien residential mortgage loans with a 70 percent or lower LTV, and a risk-weight basket of 20 percent for prime mortgage loans with a LTV above 70 percent and up to 80 percent.[9] Finally, we recommend that corresponding changes should also be made to the risk baskets for residential mortgage loans with LTVs in excess of 80 percent to more accurately reflect the risk of these loans. These adjusted baskets would make the Basel I-A approach more risk sensitive and would reduce (but not eliminate) the competitive disparity between the two systems.

2. Private Mortgage Insurance

The joint ANPR states "(B)anking organizations would determine the LTV of a mortgage loan after consideration of the loan-level private mortgage insurance (PMI) provided by an insured with an NRSRO[10]-issued long-term debt credit rating of single A or higher." We agree that PMI provides valuable credit risk mitigation and should be recognized under the capital standards. However, we disagree that PMI should not be considered when issued on a portfolio basis. Rather, we believe that PMI provides credit protection whether written on an individual loan basis or on a portfolio basis, and urge that the new capital standards recognize the benefits provided by both pool and individual loan insurance coverage.

We also disagree with the position that no capital credit should be given if the PMI contains a deductible under which the lender is required to absorb a first loss. PMI mitigates credit risk even if the lender is required to absorb a first loss, provided that the banking organization is willing to hold dollar for dollar capital against the amount of its potential first loss liabilities. If so, the banking organization should be permitted to treat the PMI as if it has no deductible. This modification would be especially important when considering a large portfolio of mortgage loans and the PMI deductible is relatively small.

3. Non-Traditional Mortgage Products

The ANPR notes that the Federal banking agencies are reviewing non-traditional mortgages, such as loans that permit negative amortization and loans that have an LTV in excess of 100 percent. The ANPR asks if these products should be dealt with in the general mortgage matrix, or if they warrant a higher capital treatment.

---

[9] These baskets would result in a Tier 1 capital charge of 40 basis points and 80 basis points, respectively.

[10] Nationally recognized statistical rating organization.

These loans can raise significant safety and soundness concerns if not properly underwritten. NAR is concerned that many borrowers do not understand the risk that come with these mortgages and is urging REALTORS® to help educate consumers about both the risks and rewards of nontraditional mortgages. However, when properly underwritten by the lender and fully understood by the borrower, non-traditional loans are often an appropriate product that provides useful alternatives for both high, middle and lower income families, especially in high-cost areas. For example, for a high income mortgagor, a low or zero down payment loan can be a useful method to provide funds for other investments at a relatively low cost to the borrower. For a middle-income borrower, non-traditional mortgage products may be used to provide a low cost source of funds for retirement plans or to provide for college savings. For many families, especially lower income families and families in high-cost areas, non-traditional loans increase the affordability of home ownership and provide a responsible method for people early in their careers to purchase a home without a large down payment.

As noted, non-traditional mortgage loans can create safety and soundness concerns when not properly underwritten. However, this is true for any type of loan that does not meet prudent underwriting standards. The failure of a banking organization to properly underwrite an extension of credit should be dealt with through the normal supervisory and examination process, and not through a capital charge that will unnecessarily penalize both banking organizations and consumers. In this regard we note that the Federal banking agencies recently published proposed guidance relating to non-traditional mortgage loans. We believe that both the guidance and any special capital rules must take a balanced approach so carefully underwritten and fully understood nontraditional mortgages remain available for borrowers to achieve homeownership, consistent with safety, soundness, and consumer protection.

4. Second Liens and Credit Lines

The joint ANPR proposes increasing the risk weight for second mortgage liens and home equity lines of credit if the combined LTV ratio of the first lien and second lien or line of credit exceeds 90 percent. The joint ANPR suggests that the risk weight for such loans could exceed 100 percent.

The risk weights for an unsecured retail loan or line of credit is 100 percent. The Basel II Accord states: "No transaction in which CRM (credit risk mitigation) techniques are used should receive a higher capital requirement than an otherwise identical transaction where such techniques are not used."[11] Credit risk mitigation techniques include collateralization requirements.[12] This principle should apply equally to both Basel II institutions and Basel I-A institutions. It simply makes no sense to penalize a bank for taking collateral when the institution could make a similar loan without collateral. We believe that to the extent that some second loans or lines of credit raise supervisory concerns, these concerns should be dealt with through the normal supervisory process and not through the capital standards.

---

[11] Basel II Accord par. 113.

[12] Basel II Accord par. 119.

5. Multi-Family Residential Mortgages

The joint ANPR notes that except for certain specially qualified multifamily residential loans, these loans are generally assigned a risk weight of 100 percent. The ANPR asks whether these loans, or a subset of these loans, should be placed in a lower risk weight basket.

The NAR believes that multifamily residences with a history of high occupancy and revenue generation are much less risky than other, more speculative multifamily loans, that the risk weight for these loans should be lowered in order to more accurately reflect the risk of these assets.

This would be consistent with the Internal Risk-Based approach authorized under Basel II. Under this approach, which would be available for large U.S. banking organizations, loans secured by multifamily residential real estate in which the funds for repayment are generated by rental income are treated as "Income Producing Real Estate" (IPRE). This group of assets is generally afforded a lower risk weight than loans secured by other types of commercial real estate.[13] Likewise, we believe that a loan secured by a multifamily residential project with a high occupancy rate and history of revenue generation should also be treated more favorably.

6. Commercial Real Estate

The Basel I framework assigns commercial real estate loans to the 100 percent risk weight basket. The joint ANPR proposes to move these loans to a higher than 100 percent risk-weight basket, unless the loan satisfies the prudential real estate lending guidelines and the loan is supported by a substantial equity investment by the borrower, such as 15 percent of the completion value.

We acknowledge that commercial real estate lending contributed to many of the banking problems in the late 1980s and early 1990s. However, since that era, many of the practices associated with commercial real estate lending have been modified, and this sector has demonstrated a very impressive history of safety and soundness. Statistics complied by the Federal Reserve Board indicate that for the past 10 years the average charge-off rate for commercial real estate loans is only 0.10 percent.

According to the FDIC, the dynamics of the commercial real estate sector have changed dramatically since the early 1990s. Public markets now play a much larger role in commercial real estate financing, due to the development of the commercial mortgage-backed securities (CMBS) market in the early 1990s. The success of the CMBS market then contributed to

[13] Under the Basel II internal risk-based approach commercial real estate is divided into two categories: income-producing real estate (IPRE) and high-volatility commercial real estate (HVCR).[13] IPRE is characterized by the fact that the repayment of the loan is based on cash flows generated by the real estate, such as rent payments. HVRE is characterized by loans secured by real estate in repayment is based on the future sale of the property, such as loans for the acquisition, development and construction of a new housing development. IPRE loans are generally given a lower risk weight than HVCR loans with similar probabilities of default. For example, a "strong" IPRE loan (with a low probability of default) is assigned a risk weight of 70 percent, but a HVCR loan with a similar probability of default is assigned a risk weight of 90 percent.

tremendous growth in the secondary market for distressed properties. The CMBS market has grown to more than $550 billion. In the mid-1990s, real estate investment trusts (REITs) also became a major force in financing CRE, with more than a seven-fold increase in market size in the past 10 years.[14]It also appears that the CMBS and REIT markets have taken on a larger share of the traditionally higher-risk types of loans.

A recent FDIC study in the Atlanta MSA that found that "(I)nsured institution risk controls and monitoring programs have improved significantly since the early 1990s. Overall, bank management has implemented more effective grading systems, improved control and approval limits, and adequate loan review procedures. Bankers understand current conditions and issues in submarkets and have access to a broader range of market information."[15] A study by the Federal Reserve Bank of Philadelphia in 2005 also noted that "current real estate underwriting and risk management practices are considered to be materially better than in the late 1980s and early 1990s, and there is presently no evidence of emerging systemic problems in the banking sector."[16]

These improvements in CRE lending were also recognized by the Basel Committee. Under the Basel II standardized approach, loans secured by commercial real estate will generally be assigned to the 100 percent risk weight basket.[17] However, in certain circumstances, mortgages on office or multi-purpose commercial premises may be assigned to the 50 percent risk weight if they meet certain LTV and other requirements.[18] We are not advocating in this letter to assign a 50 percent risk weight for commercial real estate lending, but we strongly believe that placing these loans in a weight basket in excess of 100 percent would not be appropriate. This especially would be the case where other factors are present indicating that the loan is not risky, such as when the borrower has made a substantial equity investment in the project, where the project is pre-sold under legally binding commitments, or where the project meets the requirements for Income Producing Real Estate (IPRE).[19]

NAR supports the efforts of the Federal banking agencies to improve the current Basel I standards in order to make this standard more risk sensitive and to lessen the potential competitive issues that may arise when banks implement Basel II. The NAR believes that this effort would be advanced by authorizing a lower risk weight basket for commercial assets that more accurately reflects their risk and their treatment under Basel II. We also believe that the

[14] FDIC, "Supervisory Insights: Assessing Commercial Real Estate Portfolio Risk." (June 25, 2004).

[15] Id. at 4.

[16] Federal Reserve Bank of Philadelphia, SRC Insights, "SVP Commentary on Top Commercial Real Estate Trends." (Second Quarter 2005). The study noted that there were poorly managed CRE concentrations in some institutions, and that bank supervisors should monitor CRE lending carefully.

[17] Basel II Accord par. 64.

[18] Basel II Accord par. 64, fn.29.

[19] See discussion above on multi-family residential mortgages and footnote 13.

proposal should be modified to reflect various forms in which PMI may be used to mitigate credit risk. The NAR believes that a punitive capital charge on non-traditional mortgage loans is not appropriate, and that any safety and soundness concerns with these products should be dealt with through the supervisory process. We likewise oppose a punitive capital charge for commercial real estate loans, which, according to the banking agencies, are performing well and being underwritten prudently. Finally, as a general matter, we do not believe that the capital standards should impose a higher capital requirement for collateralized loans when a banking organization could make the same loan without collateral. We thus oppose assigning second liens and home equity lines of credit to a risk weight in excess of 100 percent.

Proposed Guidance on Commercial Real Estate Lending: *NAR urges regulators to consider emphasizing the diversity of the commercial real estate markets.*

Background:
The regulators have observed that some insured financial institutions have high and increasing concentrations of CRE loans on their balance sheets, and are concerned that these concentrations may make institutions more vulnerable to losses during commercial real estate cycles. While the regulators have previously issued regulations outlining supervisory expectations for a safe and sound CRE lending program, this proposed guidance is intended to reinforce existing guidance as it relates to institutions with elevated levels of concentration in CRE loans.

The guidance notes that in the past "weak CRE loan underwriting and depressed CRE markets have contributed to significant bank failures and instability in the banking system," and that "recent examinations have indicated that the risk management practices and capital levels of some institutions are not keeping pace with their CRE concentrations."[20] The regulators propose that financial institutions with CRE concentrations adopt additional risk management measures to provide an additional safeguard against market fluctuations.

The regulators propose to define CRE loans as exposures "secured by raw land, land development and construction (including 1-4 family residential construction), multifamily property, and non-farm non residential property where the primary or a significant source of repayment is derived from rental income associated with the property." The definition also includes loans to REITs and unsecured loans to developers that closely correlate to the risk in commercial real estate markets. Concentrations that warrant heightened risk management practices would be defined as:

- Total reported loans for construction, land development, and other land represent 100% or more of the institutions total capital; and
- Total reported loans secured by multifamily and non farm non residential properties and loans for construction, land development, and other land represent 300% of the institutions total capital[21].

[20] Federal Register Vol. 71, No. 9 Friday, January 13, 2006, Notices page 2304.
[21] Ibid, p. 2305

According to the regulators, financial institutions meeting or exceeding these criteria should have heightened risk management practices. The following areas of the proposed guidance are of interest to NAR:

- Risk Assessment and Monitoring of CRE Loans: Financial institutions should maintain thoroughly articulated policies that specify criteria for risk rating CRE exposures. The risk ratings should take into account the property's sensitivity to changing market conditions.

- Portfolio Risk Management: Institutions should measure and control CRE credit risk on a portfolio basis by identifying and managing concentrations, performing market analysis, and stress testing. Risk management practices should include:

  - Management Information Systems: Institutions should stratify the portfolio by property type, geographic area, tenant concentrations, tenant industries, developer concentrations, and risk rating.
  - Market Analysis: Institutions should perform on going evaluations of the market conditions for the various property types and geographic areas or markets represented in their portfolio.
  - Portfolio Stress Testing: Institutions should consider performing portfolio level stress tests of their CRE exposures to quantify the impact of changing economic scenarios.

- Capital Adequacy: Financial institutions with CRE concentrations should recognize the need for additional capital support, beyond what is regulatorily required, for CRE concentrations in its strategic, financial and capital planning[22].

The proposed guidance provides positive recommendations for financial institutions to strengthen their risk management practices should they develop concentrations in CRE lending. It is our understanding that numerous financial institutions have similar risk management programs in place, and generally adhere to the FDIC's rules on real estate lending standards. This proposed guidance seems to be intended to address institutions who may be tempted by overheated local markets to increase exposure to certain classes of real estate lending.

Recommendation:

NAR supports agency efforts to ensure that institutions provide CRE loans based on sound underwriting principles with the finance charges priced appropriately to reflect the economic risk of each loan, however we are concerned that an overly stringent, or inconsistent application of the guidelines, may cause financial institutions to not lend to worthy projects, and as a consequence, harm the commercial real estate markets and depress property values.

Consistent with our comments that regulators should treat different classes of real estate lending separately under Basel I-A, NAR believes that the proposed guidance should emphasize that

[22] ibid, p. 2306-2307

portfolio diversity can be achieved through different types of CRE loans with varying degrees of risk. NAR recommends that regulators encourage diversity of CRE exposures across classes of commercial real estate and markets. Commercial real estate is often divided into the following classes: office, industrial, retail, multifamily condo, multifamily rental, and hospitality, each with unique performance characteristics. Though each class is tied to the overall health of the economy, some classes are more susceptible to market fluctuations than others. As part of a financial institution's portfolio risk management, NAR believes that financial institutions should be able to effectively manage risk through creating CRE portfolios that are diverse in exposures to different classes of commercial real estate in different regional markets.
The Regulators should carefully consider the effects of a revised risk-based capital regimen combined with increased risk management safeguards on the commercial real estate markets. Financial institutions may be dissuaded from making loans to, or unnecessarily raise the cost of capital for, sound commercial real estate ventures. This could hurt commercial real estate markets and depress property values. NAR has asked the regulators to carefully evaluate the potential impact the proposed guidance could have on the real estate markets before finalizing the proposed guidance.

Conclusion:

NAR believes that the commercial real estate lending guidance and the changes to Basel I-A under consideration should take into account the strength and soundness of the commercial real estate markets. so Otherwise, banks may be dissuaded from making sound commercial real estate loans and the agencies may unnecessarily and inadvertently limit the flow of capital to commercial real estate. To do so would depress property values and harm the economy beyond what is appropriate to assure safety and soundness of banks.

As noted above, institutional investors are significantly increasing their commercial real estate holdings . This is evidence of the long-term strength and stability of the commercial real estate market. Furthermore, as noted in our discussion of Basel I-A issues, studies by the FDIC and Federal Reserve underscore the point that underwriting procedures and risk management practices have improved dramatically since the late 1980's and early 1990s.

NAR is also concerned that potential revisions to Basel I-A capital requirements and the proposed commercial real estate lending guidance may put smaller banks at a significant competitive disadvantage to the larger Basel II banks. Basel II banks are likely to enjoy more favorable risk weights on commercial loans, and, therefore, hold a much broader and larger loan portfolio, and are much less likely to develop concentrations in real estate lending.

NAR looks forward to working with members of the Banking Committee and the financial regulators to ensure that the commercial real estate markets remain strong.

We appreciate this opportunity to express our views on these important issues.