A PRIMER ON THE BASEL III MORTGAGE-RELATED PROVISIONS AND THEIR HOUSING FINANCE IMPLICATIONS

Raymond Natter
Barnett Sivon & Natter, P.C.
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1. <u>What is the Basel Committee on Banking Supervision</u>?

- Established in 1974.
- Informal organization consisting of the chief banking regulatory authorities and central banks from the world's leading economic countries.
- No legal authority.
- In the U.S., Basel agreements must be implemented through regulatory changes.

2. <u>What are the Purposes of the Basel Capital Accord</u>?

- Beginning in 1988, the Basel Committee addressed two perceived weaknesses in the capital requirements then in place:
    - Lack of Uniform Capital Standard.
    - Lack of Risk Sensitivity.
- International Uniformity is necessary to prevent an institution from gaining an unfair advantage due to lower capital requirements in its home country.
- Risk sensitivity is necessary so that an institution holding riskier investments will have to have more capital backing those investments. Without adjusting capital to risk, a banking institution would be able to increase earnings and potential profits without having to hold additional capital.
- Following the financial crisis that began in 2007, the Basel Committee added additional goals for its capital framework:
    - Enhance the quality of capital instruments.
    - Increase the amount of the required capital and add a buffer.
    - Reduce systemic risk through a counter-cyclical capital requirement.
    - Further enhance risk sensitivity.
    - Impose a new liquidity requirement.

3. <u>What is the Impact of Basel III on Mortgage Finance</u>?

- Basel III proposed rules will significantly increase the amount of capital necessary to support most mortgage loans, whether held on portfolio or securitized.
- The increase will be felt by both large international banks subject to the so-called "advance approaches" and to regional and community banks using the simpler framework.
- Higher capital charges will result in either higher interest rates for mortgage loans, or less availability of mortgage finance, or both.

- The new rules will favor loans that are supported by large cash down payments and meet other underwriting criteria. As a result, generally available mortgages are likely to fit into one or two specific "plan vanilla" molds.

- The hardest hit will be first time home buyers and others who cannot afford cash down payments of 20 percent or more.

- Also hard hit will be specialized loans, such as those with balloon payments, and home equity lines of credit.

4. <u>What is the Proposed Risk Weight for Residential Mortgages Held in Portfolio</u>?

- 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. Private mortgage insurance is recognized in determining the mortgage's LTV.

- Under the proposal, mortgages are divided into two categories, and then subdivided based on the loan-to-value ratio (LTV).

- Private mortgage insurance will no longer count when determining LTV. A home buyer with a 5 percent cash down payment who obtains mortgage insurance for 20 percent of the loan, will be considered as having a 95 percent LTV for capital purposes.

- Category 1 mortgages have significantly lower capital charges than Category 2 loans.

5. <u>What are Category 1 Mortgages</u>?

Category 1 mortgages must meet the following criteria:

- First mortgage, except first and second liens held by the same bank, with no intervening lien, may be considered as one loan for capital purposes.
- 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.

- 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.
- The loan may not be 90 days or more past due or placed in non-accrual status.

6. <u>What are Category 2 Mortgage Loans?</u>

- 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.

7. <u>What are the Risk Weights for Category 1 and Category 2 Mortgages</u>?

Category 1 Loans

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

Category 2 Loans

LTV	**Risk-Weight**
Equal to or less than 80 percent	100 percent
Greater than 80 percent by equal to or less than 90 percent	150 percent
Over 90 percent	200 percent

8. <u>How are Mortgage Servicing Rights Affected</u>?

- Mortgage servicing refers to activities such as collection of loan payments, sending notices, arranging for escrow accounts, paying taxes and insurance, and in the event of a default, taking steps to cure the default or foreclose.

- The right to conduct and to be paid for these activities are known as "mortgage servicing rights," and they may be retained by the original lender or sold to a third party.

- Current rules require a bank to mark to market mortgage servicing rights quarterly, and to haircut the value of this asset by 10 percent. Mortgage servicing rights in excess of 100 percent of Tier 1 capital must be deducted from capital.

- 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.

- The result is that the value of mortgage servicing rights will decline, thus decreasing the value of mortgages for a lending institution that intends to sell the servicing rights to another company, for example, in connection with a securitization. It will also adversely impact banks holding loans in portfolio, but who wish to sell the servicing to a different financial institution that specializes in this area.

9. What is the Treatment of Modified or Restructured Loans?

- Under current rules, a restructured loan is not eligible for the 50 percent risk weight, and is therefore given a 100 percent risk weight.

- Under the proposed regulation, a modified or restructured loan is not automatically disqualified from beneficial capital treatment. However, a restructured loan can only qualify for a risk weight of less than 100 percent if it is a Category 1 loan, and a risk weight for a Category 2 loan can only qualify for a risk weight of less than 200 percent if the LTV of the loan is updated at the time of the restructuring. HAMP loans are not considered to be modified or restructured.

10. What is the Impact on Mortgage Securitization

- Securitization will be affected by a number of proposals in addition to Basel III.
  - Credit risk retention under Dodd-Frank and the QRM.
  - Potential liability under the "Ability to Repay."
  - The scope of the QM and whether it is a safe harbor or a presumption.

- The Basel capital proposal adds a number of other disincentives:

  - Any GAAP recognized gain on sale from the securitization must be subtracted from tier 1 capital.

  - Any resulting credit-enhancing interest only strips are risk weighted at 1,250 percent.

  - Mortgage servicing assets generated by the securitization are limited to 10 percent of tier 1 capital, and risk weighted at 250 percent.

  - Reps and warranties concerning early defaults and premium refunds with respect to assets guaranteed by the U.S. Government or a GSE will not be allowed. Reps and warranties concerning fraud, misrepresentation or incomplete documentation will still be permissible.

- Community and possibly even regional banks will be driven out of the market for private label mortgage-backed securities.

  - Any banking institution wishing to invest in a private label mortgage-backed security will have to undertaken an analysis of the structural features of the security, such as cash flow, waterfall structure, credit enhancements, legal definition of default, and the performance of the underlying mortgages.

  - This analysis must be conducted on a quarterly basis to the satisfaction of the bank's primary regulator.

  - It is unlikely that any but the largest banks will be able to devote the necessary resources to undertake this quarterly analysis, thereby driving small banks out of this market.

11. <u>How Does Basel III Affect Commercial Real Estate Loans</u>?

- The current rules assign acquisition, development and construction loans to the 100 percent risk weight basket.

- The proposed regulation would increase the risk weight for these assets to 150 percent, unless the loan facility is financing a project that meets specified standards regarding the LTV, the borrower has contributed at least 15 percent of the appraised (as completed) value before any advance from the bank, and certain other requirements are met.
- The increased risk weight does not apply to projects to build 1-4 family residences.

- The increased risk weight also does not apply if certain LTV ratios are met, the developer contributed at least 15 percent of his or her own capital, and other specified conditions are met.

12. <u>How Does Basel III Affect Banks Using the Advanced Approaches</u>?

- The very largest banking institutions in the country are required to use internal models, rather than prescribed risk weights, for determining minimum capital.

- The Basel III proposal would make significant changes in these models to ensure that the banks are using highly stressed economic conditions, such as those that occurred in the recent past.

- Since the economic crisis resulted in significant losses, defaults in mortgage loans and mortgage-backed securities, the use of inputs will result in significantly higher capital charges for these mortgage related assets under the new framework.

13. When are the New Rules Expected to go into Effect?

- If adopted as proposed, the new risk weights will go into effect in January 2015.

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