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Proposed Basel III Capital Rules for Mortgage Loans Would Further Push Mortgage Market to Homogeneous Products

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Banks that are concerned about potential fair lending claims if they refuse to make residential mortgage loans that are not "qualified mortgages" or "qualified residential mortgage loans" should be equally concerned about the new proposed bank capital rules. On June 7, 2012, the Federal Reserve approved for publication three sets of proposed regulations to revise the risk based capital rules for banks to make them consistent with the new international capital standard, generally known as Basel III, and certain requirements of the Dodd-Frank Act. The Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation followed suit on June 12, 2012. Conventional residential mortgage loans with loan-to-value ratios in excess of 80%, regardless of the presence of private mortgage insurance, could trigger material adverse capital requirements if the loans are held for investment and do not comply with certain regulatory underwriting criteria. Such loans could present the legal risk of loss under the "ability to repay" rules, the credit risk of loss under the "risk retention" rules and now increased capital charges under the implementation of Basel III.

Given the interagency nature of the proposed rulemaking, the proposed rules would apply to all FDIC-insured institutions and national banks in the United States, as well as bank holding companies (other than small bank holding companies) and all thrift holding companies. Although these proposed rules would not apply to credit unions, the National Credit Union Administration, the federal regulator for credit unions, has historically implemented credit union net worth requirements that closely track bank capital requirements, making the proposed bank capital rules a harbinger for future credit union net worth requirements.

Among the most significant changes in these far-reaching proposals relate to the capital treatment of mortgage loans, mortgage backed securities and mortgage servicing rights assets held by banks. These rules would vary the amount of capital banks must hold against residential mortgage loans based upon loan-to-value ratios and compliance with regulatory underwriting criteria. They would also impose significant restrictions on the inclusion of mortgage servicing rights in capital. Following the qualified mortgage rules under the Truth in Lending Act and the exemption from risk retention for securitizations of qualified residential mortgages, the new capital rules are one more step in what appears to be an orchestrated campaign of pushing banks to originate plain vanilla residential mortgage loan products. These rules may also affect non-bank lenders through their effect on the market for mortgage products.

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Background on Capital Rules

Regulatory capital requirements are designed to ensure that banks retain a sufficient cushion to absorb losses during times of economic stress. Capital is generally measured as a ratio of capital components (i.e., tier 1 capital, tier 2 capital, etc.) compared to risk-weighted assets. Low risk assets such as government securities generally require little or no capital cushion, but assets that present greater risk require a larger capital cushion. The risk weighting of assets is the mechanism by which regulators both determine the amount of capital required for specific types of assets and indirectly influence the type of activities in which banks elect to engage.

Since the implementation of the Basel II Capital Accord in 2006, two sets of capital rules have effectively governed the U.S. banking industry: the standardized approach and the advanced approach. The standardized approach is used by most banks to calculate capital and capital is determined by assigning risk weighting for assets based upon regulatory criteria. Banks with more than $250 billion in assets, however, are permitted to use the advanced approach, which measures capital using regulatory formulas that incorporate inputs determined in accordance with a bank's internal ratings-based system. Banks need to qualify to use the advanced approach and there is a process to ensure that the internal ratings systems are sufficiently robust. Banks that utilize the advanced approach will also be subject to the standardized approach insofar as the standardized approach will set the floor on the total amount of capital required at such banks.

With regard to residential mortgage loans, the most significant changes proposed are to the standardized approach, which could affect the extent to which (or the pricing at which) banks are willing to hold loans in portfolio.

Capital Treatment of Residential Mortgage Loans

The changes affecting capital treatment of mortgage loans primarily impact banks that use the standardized approach – banks with less than $250 billion in assets. The proposed rules make no changes to the capital treatment of mortgage loans guaranteed by the U.S. government or an agency of the U.S. government. Loans that are unconditionally guaranteed would retain a risk weighting of zero, while loans that are conditionally guaranteed will retain a risk weighting of 20%. For loans that are not guaranteed by the U.S. government or a U.S. government agency, risk weightings will change from a uniform 50% to anywhere from 35% to 200%, with the lower risk weightings available only to mortgage loans that conform to narrow regulatory criteria. Risk weightings, and therefore capital requirements, increase with an increased loan-to-value ratio.

Specific risk weightings are as follows:

Loan-to-value ratio (in percent)	Category 1 residential mortgage exposure (in percent)	Category 2 residential mortgage exposure (in percent)
Less than or equal to 60	35	100
Greater than 60 and less than or equal to 80	50	100
Greater than 80 and less than or equal to 90	75	150
Greater than 90	100	200

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The loan-to-value amounts are determined based upon the maximum principal amount of the loan, which would be the total line of credit for a HELOC and outstanding principal balance for fully funded residential mortgage loans. For junior lien loans, the loan-to-value ratio would also include the funded and unfunded commitments on any senior loan. The value of the property would be the lesser of acquisition cost or the appraised or estimated value of the property at origination (depending upon whether an appraisal or estimate is required). The loan-to-value ratio would be updated at the time of any restructuring or modification of the related loan. This appears intended to create an incentive for principal reduction, as the capital required for a loan could be reduced by modifying the loan to reduce the loan-to-value ratio.

Residential mortgage loans that conform to narrow regulatory criteria, including senior lien status, maximum thirty-year term, no deferrals and no negative amortization, are classified as "category 1." All other residential mortgage loans are classified as "category 2." The effect of this is that mortgage loans that do not conform to category 1 underwriting criteria will require at least twice as much capital as those that conform. For example, under the standardized approach, a loan with a 20% loan-to-value ratio that does not conform to the category 1 criteria would require twice as much capital as a loan with an 80% loan-to-value ratio that conforms to the category 1 criteria. The presence of private mortgage insurance is <u>not</u> considered in determining the risk weighting percentage, regardless of the loan-to-value ratio.

Even if a loan meets the criteria for a category 1 loan, the primary federal regulator for a bank may nevertheless determine that the loan is not prudently underwritten and require that the loan be treated as category 2. It is a one way street: a category 1 loan can be deemed category 2, but a category 2 loan – no matter how little risk it presents – can never be deemed category 1. This may give bank examiners increased authority to unilaterally require increased capital at individual banks based upon underwriting practices; but will not provide any discretion to allow lower levels of capital for low-risk loans that do not fit category 1 criteria.

The specific criteria for "category 1" residential mortgage loans, which are substantially similar to the statutory definition of "qualified mortgage" under the ability to repay requirements in the revised Truth in Lending Act, are as follows:

- the duration of the mortgage does not exceed 30 years;
- the residential mortgage loan is not a junior lien loan except where the same institution holds both a first-lien and junior lien mortgage exposure, with no intervening liens, in which case the junior lien may be treated as a category 1 exposure if each residential mortgage exposure has the characteristics of a category 1 residential mortgage exposure;
- The terms of the mortgage loan provide for regular periodic payments but do not allow negative amortization, deferral of payments of principal or balloon payments;
- The terms of the residential mortgage loan allow the annual rate of interest to increase no more than two percentage points in any twelve month period and no more than six percentage points over the life of the exposure, in the case of adjustable rate loans;
- The standards used to underwrite the residential mortgage loan: (i) take into account all of the borrower's obligations; and (ii) result in a conclusion that the borrower is able to repay the loan using: (A) the maximum interest rate that may apply during the first five years after the date of the closing of the residential mortgage loan; and (B) the amount of the residential mortgage loan is the maximum possible contractual exposure over the life of the mortgage as of the date of the closing of the transaction;

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- The determination of the borrower's ability to repay is based on documented, verified income;
- For a first-lien home equity line of credit (HELOC), the borrower must be qualified using the principal and interest payments based on the maximum contractual exposure under the terms of the HELOC; and
- The residential mortgage loan is not 90 days or more past due or on non-accrual status.

Similar to the qualified mortgage rules, noticeably absent from these criteria are the credit scores or credit history of the borrowers, which may go more to willingness to repay than ability to repay.

By contrast, the capital treatment for mortgage loans under the advanced approach remains virtually unchanged. The formula to determine the risk weighting on mortgage loans is identical in the proposal to that under current capital rules, with one notable change to one of the inputs. Two key parameters under the advanced approach are loss given default and probability of default, each of which is determined by a bank using its internal ratings-based system. Loss given default is an estimation of the economic loss a bank would expect to incur upon the default of a loan over the course of a one-year horizon. For residential mortgage loans that are not guaranteed by a government or agency, loss given default would remain subject to a floor of 10%. Probability of default is an estimation of the long-run average one-year default rate for credit exposures in a given segment. The proposed rule would delete a requirement in the current rule to adjust probability of default upward for segments in which seasoning effects are material (i.e., loan types in which there is a material relationship between the time since origination and rates of default).[*] Presumably, no material revisions to the regulatory formula was required as it provides a means for differentiating mortgage products based upon risk presented.

The difference in capital required between the standardized approach and advanced approach may become more acute under the proposed regulations. The advanced approach takes into account the riskiness of a loan through the use of loss given default and probability of default in the calculation of capital required to be held against the loan. These are addressed in the standardized approach only indirectly through loan-to-value ratios and the regulatory underwriting criteria for category 1 loans. Mortgage loans with low loss given default and low probability of default that do not meet the category 1 criteria could require much greater amounts of capital under the standardized approach versus the advanced approach.

Three points are worth noting. First, the capital rules only apply to loans held for investment. This means that banks with under $250 billion in assets could originate and sell loans that, if held for investment, might have significant negative capital consequences. Thus, it is possible that one consequence of these capital rules, if adopted, will be to push innovative products for creditworthy borrowers to banks using the advanced approach, thereby depriving community and regional banks of potential niche markets.[†] At the same time, though, community and regional banks could broker or sell such products to banks that use the advanced approach or otherwise have flexibility to hold such loans in portfolio.

[*] The preamble to the advanced approach proposed rules suggests that seasoning of loans would be dealt with in the context of long-term capital planning.

[†] While the standardized approach would set the floor for total capital at banks that use the advanced approach, it is unclear what the effect of differences in risk weights for specific assets will be on banks that use the advanced approach. It may be that total capital required under the advanced approach could be greater than or equal to total capital that would be required under the standardized approach notwithstanding lower capital required for some mortgage loans, as such lower capital requirements on mortgage loans could be offset by greater capital requirements for other asset classes.

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Second, *the fair lending implications of these capital rules are enormous*. Much conversation has surrounded whether lenders and securitizers are willing to accept the legal and credit risks of originating non-qualified mortgage loans or non-qualified residential mortgage loans. There now is a material third impediment to originating such loans—the materially increased capital requirements of holding such loans in inventory. If these loans are priced to account for the increased capital requirements, they may trip "high cost" triggers and make the loans virtually toxic. On the other hand, if the market dries up for such loans because banks refuse to hold them for investment, one should expect that the fair lending advocates in the federal government would consider bringing disparate impact claims. Query whether the federal banking agencies that wrote these capital rules will call their colleagues at the Departments of Justice and Bureau of Consumer Financial Protection and assert that banks have a legally justifiable basis to refuse to make such loans.

Third, the capital requirements are not mitigated by the presence of private mortgage insurance as the loan-to-value ratio is not adjusted to reflect coverage. This may put a damper on many first-time homebuyer and other programs that incorporate private mortgage insurance as a key component.

Capital Treatment of Mortgage Backed Securities

The proposed rules also update the treatment of securitization exposures. The key determinant of whether a given exposure would be subject to the securitization capital rules is the presence of tranches. In other words, an exposure would be treated as a securitization exposure if there are varying levels of seniority, such as with senior/subordinate REMIC structures. The legal structure is less important than the economics of the transaction. Thus, loan participations with tranching of credit risk could be treated as securitization exposures while mortgage-backed pass-through certificates (such as certain of those guaranteed by Ginnie Mae (non-REMIC), Fannie Mae or Freddie Mac), which do not involve tranching of credit risk, would not be treated as securitizations under the proposal.

For large institutions that are subject to the market risk rule, the supervisory formula approach or simplified supervisory formula approach is used. For all other institutions, a gross-up approach is applied using the following four parameters: the pro rata share, the exposure amount, the enhanced amount, and the applicable risk weight. Regardless of which approach is used, the weighted average risk-weighting of the underlying assets would be incorporated. The changes to risk-weighting of residential mortgage loans discussed above will therefore also have a direct impact on the capital treatment of securitizations of residential mortgage loans.

Mortgage Servicing Rights

Treatment of mortgage servicing rights under the proposed rules is significantly worse for banks as the deduction from tier 1 capital for mortgage servicing rights will be significantly increased. Currently, the value of intangible assets, including mortgage servicing rights, is limited to 100% of tier 1 capital, with no sub-limit for mortgage servicing rights. Under the proposal, mortgage servicing assets would be capped at 10% of common equity tier 1 capital, with any excess being deducted from common equity tier 1 capital. Further, mortgage servicing rights, deferred tax assets and significant investments in common stock of other financial institutions would be subject to an aggregate cap of 15% of common equity tier 1 capital. Mortgage servicing rights, to the extent not deducted from common equity tier 1 capital, would be assigned a risk-weighting of 250% under the proposals, as compared to 100% under current rules. Mortgage servicing assets are currently valued at the lesser of 90% of fair market value and 100% of the remaining unamortized book value. Under the proposed

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rules, valuation of mortgage servicing rights would be set at 90% of fair market value, with a requirement to determine such market value quarterly.

The proposed capital rules promise significant change to banking institutions. It is therefore important for banking institutions to analyze how these proposed rules would affect them and begin to consider transition plans. These are proposed rules subject to public comment. Comments must be submitted on or before September 7, 2012. Institutions should be ready to comment with issues that affect them, particularly those that arise under the proposed capital rules that do not arise under the Basel III framework.

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