Basel III Capital Proposals: Presentation to the Mortgage Bankers Association

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• On June 12, 2012, the Federal banking agencies (the OCC, Federal Reserve Board and FDIC) (the “Agencies”) formally proposed three sets of significant changes to the U.S. regulatory capital framework:
  • The Basel III Proposal, which applies the Basel III capital framework to almost all U.S. banking organizations
  • The Standardized Approach Proposal, which applies certain elements of the Basel II standardized approach for credit risk weightings to almost all U.S. banking organizations
  • The Advanced Approaches Proposal, which applies changes made to Basel II and Basel III in the past few years to large U.S. banking organizations subject to the advanced Basel II capital framework.

• Deadline for comments on all three proposals is Sept. 7, 2012. This deadline may be extended, but the regulators intend to finish the rules by year-end.
• Applicability
  • All FDIC-insured depository institutions
  • U.S. bank holding companies and savings and loan holding companies
  • Basel II “advanced approaches” institutions—by virtue of the Collins Amendment
  • Small bank holding companies (consolidated assets of $500 million or less) are not covered.
  • Foreign banking organizations are not covered, but any subsidiaries that are U.S. bank holding companies are covered.
Basel III

• Three categories of capital
  • Common equity Tier 1 – common stock, retained earnings, certain minority interests, and AOCI
  • Tier 1 Capital -- common equity Tier 1 capital and additional Tier 1 capital
  • Total Tier 1 capital, plus Tier 2 capital, would constitute total risk-based capital.
Deductions from Capital

• Deductions from common equity Tier 1 capital:
  • Securitization gain-on-sale
  • Credit-enhancing interest-only strips that reflect after-tax gain on sale
  • MSAs
    • Deduct amount that exceeds 10% of CET1
    • Deduct sum of total amount of non-deducted MSAs, DTAs, and amounts of significant investments in other financial institutions that exceeds 17.65% of remaining CET1
    • Additional deduction if necessary to result in total deduction of 10% of FMV
• Effective Dates/Transitional Periods
  • Minimum Tier 1 capital ratios – 2013-2015
  • Regulatory capital adjustments and deductions -- 2013-2018
Mortgage Risk Weights

• **Applicability.** The same institutions subject to the Basel III Proposal

• **Proposed Effective Date.** Jan. 1, 2015. Banks may opt in earlier

• MSA deduction requirement will take effect sooner than new risk weights
Mortgage Risk Weights

- Behaviour modification
  - Non-traditional loans
  - Originate-to-distribute
  - Opaque transactions
  - Reliance on rating agencies
Mortgage Risk Weights

• Category 1 (traditional) vs. Category 2 (non-traditional)
• Category 1 is close but not identical to proposed definition of “qualified mortgage”
Mortgage Risk Weights

• Category 1 criteria
  • Term not longer than 30 years
  • Regular periodic principal payments
  • Underwriting standards
  • Limits on interest rate increases
  • Documented, verified income
  • Not more than 90 days past due or on non-accural status
  • First-lien only

• Special rule for HELOCs
Mortgage Risk Weights

• Regular periodic principal payments
  • May not result in increase in principal balance
  • May not allow borrower to defer principal payments
  • May not result in a balloon payment
Mortgage Risk Weights

• Underwriting requirements
  • Take into account all of borrower’s obligations
    • Principal, interest, taxes
    • Insurance including mortgage insurance
    • Assessments
  • Result in conclusion of ability to repay based on:
    • Maximum interest rate that may apply in first five years
    • Exposure at closing is maximum amount of exposure over life of the loan
Mortgage Risk Weights

• Interest rate limits
  • Rate may not increase by more than two percentage points within a 12-month period
  • Rate may not increase by more than six percentage points over the life of the loan
Mortgage Risk Weights

• HELOC issues
  • First-lien only
  • Borrower must be qualified based on maximum contractual principal and interest payments
Mortgage Risk Weights

Eight tiers

Not guaranteed by U.S. government, agency, or GSE

<table>
<thead>
<tr>
<th>LTV</th>
<th>Category 1</th>
<th>Category 2</th>
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<tr>
<td>&lt;60%</td>
<td>35%</td>
<td>75%</td>
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<td>&gt;80, &lt;90</td>
<td>75</td>
<td>150</td>
</tr>
<tr>
<td>&gt;90</td>
<td>100</td>
<td>200</td>
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</table>
Mortgage Risk Weights

• Value is lesser of
  • Actual acquisition cost (if a home purchase)
  • Appraised value at the time of origination or restructuring/modification
    • Appraisal must satisfy existing regulatory requirements
Mortgage Risk Weights

• Guarantees continue in effect
  • U.S. government (FHA, VA): 0%
  • U.S. government agencies: 20%
  • GSEs: 20%
Mortgage Risk Weights

• Restructured or modified loans
  • Category based on new terms
  • 100% risk weight for Category 1 loan, unless LTV updated
  • 200% risk weight for Category 2 loan, unless LTV updated
  • HAMP modifications retain original risk weight
Mortgage Risk Weights

Other issues

• Junior liens
  • Category 2
  • If first and junior liens held by same lender with no intervening creditor, Category 1 available, if terms of both loans qualify

• Past-due loans
  • Category 2
Mortgage Risk Weights

Multifamily Mortgage Loans

• Risk weight 100% for the first year

• Thereafter, weight drops to 50% under four conditions:
  • All P&I payments timely made for the first year
  • Loan amortizes over 30 years or less
  • Term of the loan not be less than 7 years
  • Fixed rate loan: LTV 80%; NOI may not exceed annual debt service by more than 20%.
  • Adjustable rate: LTV 75%; NOI cap 15%
Mortgage Risk Weights

Residential Construction Loans

• Current treatment continues
  • Construction loans for one-to-four family residential pre-sold properties generally risk-weighted at 50%
  • If home purchaser cancels purchase contract for completed residence the construction loan risk-weight increases at 100%

• Additional conditions
  • Builder must incur at least the first 10% of direct costs of construction (including land) before the builder may draw on the loan
  • Construction loan amount may not exceed 80% of the sales price of the pre-sold residence
Securitization Exposures

• Operational requirements
  • Due diligence
  • Traditional securitizations
  • Synthetic securitizations
  • Clean-up calls
Securitization Exposures

- Amount of on-balance sheet
  - Carrying value
- Amount of off-balance sheet
  - Notional amount
  - Eligible ABCP liquidity facility, depends on whether SSFA applies
- Repo-style transactions, eligible margin loans, and derivative contracts
  - OTC derivative contract
  - Collateralized transaction
Securitization Exposures

• 20% floor
• Risk-weighting alternatives
  • SSFA
  • Gross-Up Approach
  • Other
Securitization Exposures

• Common equity Tier 1 issues
  • Gain on sale
  • Credit-enhancing interest-only strips
  • MSAs—at least 10% of FMV

• Risk weights on remainders
  • CEIOs that do not reflect after-tax gain on sale—1,250%
  • MSAs post-deduction—250%
Securitization Exposures

• Types of credit risk mitigants
  • Collateral
  • Credit derivative
  • Guarantee

• Requirements
  • Eligible guarantors
  • For credit derivatives and guarantees, adjustments for maturity mismatches, currency mismatches, and credit derivatives without restructuring as a credit event