Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

Barnett Sivon & Natter P.C.
ATTORNEYS at LAW
WASHINGTON, DC

The Conflict Between Public Policy and Basel III*

Raymond Natter

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The economic recovery of the United States depends, to a significant extent, upon the recovery of our housing markets. Mortgage rates are at historic lows, and the recent announcement that the Federal Reserve will aggressively purchase mortgage-backed securities for the indefinite future is driving down rates even further. The goals are clear. Low interest rates drive up the value of real estate, increase the demand for both re-sales and new construction, and provide an opportunity for consumers to refinance out of higher rate mortgages and into lower cost loans. Additional housing sales and new construction are particularly important, since there is a vast amount of employment generated when homes are constructed and newly purchased homes are furnished. In short, lowering the cost, and enhancing the availability of mortgage financing will provide an important boost to our economy, reduce the number of underwater loans, and consumers will have more disposable income to spend on a variety of products.

However, there are impediments to achieving these results. Private investors are reluctant to invest in mortgages that are not backed by the U.S. Government. As a result, the overwhelming majority of mortgage finance is backed by the Federal Government, e.g., FHA guaranteed or generated through Fannie Mae or Freddie Mac issued securities. In addition, banks and other lenders have raised underwriting standards, limiting the number of consumers who can obtain a mortgage or refinance a current loan. According to Zilliow.com, approximately one-third of all Americans cannot qualify for a home mortgage today, even with a loan-to-value ratio (LTV) of 75 percent. One respected survey of over 2 million mortgages found that the average FICO score for an approved mortgage loan has increased to 750.[1] Even the minutes of the Federal Open Market Committee indicate concern about the restraint on growth imposed by tight credit standards for

*The information contained in this newsletter does not constitute legal advice. This newsletter is intended for educational and informational purposes only.

[1] See ***Ellie Mae Origination Insight Report***.

mortgage loans.[2]

Everyone agrees that additional private capital should be at risk in mortgage financing, and must be brought into our housing finance framework. Further, there is agreement among our country's leaders that mortgage interest rates should be as low as possible, and that mortgages should be more available to creditworthy homebuyers. Unfortunately, the recently published Basel III regulatory proposals would have the opposite effect. The proposal would significantly raise the capital requirements on many home mortgages held in portfolio, as well as on private label mortgage-backed securities. Higher capital charges typically are offset by higher interest rates for the loan, or result in reduced credit availability, since a bank's funds can be employed more profitably on loans with a lower capital charge.

The proposal also makes it harder for banks to originate mortgages and then sell them into a securitization vehicle. It makes securitization more expensive through several changes in the capital rules. It also encourages the growth of Fannie Mae and Freddie Mac by giving the securities they issue very favorable capital treatment, while imposing extensive paperwork impediments on the purchase of privately issued mortgage backed securities. The capital charges for privately issued mortgage backed securities are also likely to increase under the proposal. The mortgage market's dependence on Fannie Mae and Freddie Mac will increase, and mortgages that are not eligible for purchase by these GSEs will be much more expensive.

These proposals would make sense if the increased capital required for mortgage loans was linked to evidence of increased risk for these products going forward. However, as explained above, the underwriting standards for newly issued mortgages are already overly stringent. Further, new regulations to be issued under the Dodd-Frank Act will make it impossible to return to the reckless lending we saw during the housing bubble. The proposed regulations also limit the use of non-traditional practices, such as "no doc" lending and the use of artificially low teaser rates or interest-only payment options. Going forward, mortgage lending will have to be conservative, and the rates of default and delinquency should return to the historic levels experienced before the housing bubble.

Imposing higher than necessary capital charges is bad for the economy, hurts employment, and is contrary to the public policies described above. If

[2] FOMC Minutes for Sept. 12-13, 2012.

a regulator determines that a particular bank is engaging in reckless mortgage underwriting, it can take various actions to stop that practice, including issuing emergency cease-and-desist orders. The agencies also have the authority to increase required capital based on the unsafe or unsound lending practices of a particular institution or group of institutions. However, the proposed regulation would increase the capital required for all mortgages with an LTV in excess of 80 percent, without considering such factors as the credit rating of the borrower, or the debt-to-income ratio that the borrower would have if the loan is granted. This simply does not make sense.

I are not arguing that the current capital requirements are fully satisfactory, or that no change in the agencies' capital rules is necessary. I do believe that any modification should take into account its likely impact on the economy, employment and other established policies of the United States, and that a thorough factual and impact analysis must be conducted to ensure that any modification in the capital required for a mortgage loan is closely correlated to the risk inherent with that loan.

Raymond Natter is a partner with the law firm of Barnett Sivon & Natter, P.C.