



# ***ISSUE PAPER***

***Subject:*** Proposed Basel II and Basel IA Capital Standards

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**Issue:** Two proposals are outstanding that would change the regulatory capital standards for regulated institutions (banks) in this country. The proposed Basel II standards would replace the existing Basel I capital standards for large qualifying banks, and the proposed Basel IA standards would be available to all other banks. MBA has consistently advocated that final Basel IA and Basel II standards not impose overly conservative capital requirements on banks' interests in residential and commercial real estate.

**Background:** For the past several years, the Federal Reserve Board (Board), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS) (collectively, the banking agencies) have been engaged in an effort to improve the existing risk-based Basel I capital standards for banks in this country. The Basel I framework has been in effect since 1989, following the 1988 Basel Capital Accord which was entered into by bank supervisory authorities from ten countries, including the U.S. Basel II and Basel IA are intended to address the rudimentary treatment of credit exposures in Basel I.

The Basel IA and Basel II proposals were developed, in large part, to make them more risk sensitive. They also are intended to enhance market discipline, support a level playing field in an increasingly integrated global financial system, establish and maintain a minimum capital cushion sufficient to foster financial stability in periods of adversity and uncertainty, and ground risk measurement and management in actual data and formal quantitative techniques. The more recently developed Basel IA proposal is intended to counter concerns that differences between the Basel I and Basel II standards would create competitive disparities among banks.

Some highlights of the proposals are described below:

## Basel IA:

The Basel IA proposal (released in December 2006) reflects comments made by MBA in previous letters on Basel II that the capital requirements for commercial and residential real estate credit exposures under Basel I are overly conservative. As proposed, the Basel IA standards would expand the categories of risk weights to which

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credit exposures can be assigned from five to nine, extend the use of external credit ratings to risk weight certain exposures, expand the range of recognized collateral and eligible guarantors, and permit the use of loan-to-value (LTV) ratios to risk weight most residential mortgages. MBA believes the greater flexibility provided by the proposed Basel IA standards will make them very appealing to banks that would not be eligible to adopt the Basel II standards. Basel IA has an opt-in provision for participating in the Basel IA framework, whereas participation in Basel II is mandatory for certain large banks.

#### Basel II:

The Basel II proposal (most recently released in September 2006) would also permit greater flexibility in assigning weights to commercial and residential credit exposures, consistent with MBA comments on previous proposals. For example, the latest proposal would permit entities to calculate risk weights for credit risk exposures (including mortgage loans) using their own estimates of “loss given default,” a key variable in the calculation for determining the weights. For U.S. domiciled banks that fall under the Basel II regime, they must employ the Advanced Approach. The Advanced Approach requires banks to implement sophisticated risk management analysis systems in order to generate the data required for the Advanced Approach. However, foreign-based banks in Europe have the option of adopting the International Standardized Approach, which requires much less sophisticated and costly analysis of credit risk.

**MBA Position:** The capital rules for U.S. banks should accurately reflect the economic risks of commercial and residential mortgage lending activities to ensure the continued growth and vitality of the U.S. real estate markets. Accordingly, MBA will examine new capital regulation by the following set of principles.

- **Required minimum capital should be closely aligned with risk.** Banks today utilize ever more sophisticated means to measure and manage their risk exposures. Regulatory capital requirements should recognize and reflect these improvements in risk management capabilities with greater flexibility and greater compatibility with economic capital allocations. In particular, MBA backs all regulatory efforts aimed at aligning the capital requirements for banks’ interests in real estate, most particularly interests in mortgages, with their economic risks. Similarly, the MBA believes the existing leverage ratio should be reassessed in conjunction with a successful implementation of the Advanced Basel II regime.
- **Regulators should not create competitive disparities among banks, including foreign and domestic banks, as a result of regulation.** Regulators should be aware of and to the extent possible mitigate the differential impact of new requirements on larger banks that may benefit at the expense of smaller banks. Similarly, regulators should strive to eliminate differences in the proposed implementation of Basel II by domestic and foreign domiciled banks.

