

**2003 SENIOR OFFICERS**

November 3, 2003

*President*

**C. KENT CONINE**  
CONINE RESIDENTIAL  
GROUP, INC.  
Dallas, TX  
(877) 668-5368  
(972) 668-6600  
FAX: (972) 668-6700  
E-MAIL: kent@conine.com

Ms. Jennifer J. Johnson  
Secretary  
Board of Governors of the Federal Reserve System  
20<sup>th</sup> Street & Constitution Avenue, NW  
Washington, DC 20551  
Attention: Docket No. R-1154

*First Vice President*

**JAMES R. RAYBURN**  
RAYBURN & ASSOCIATES  
Jackson, MS  
(601) 856-1761  
FAX: (601) 853-6650  
E-MAIL: bobby.rayburn@nahbofficer.com

**Re: Risk-Based Capital Guidelines; Implementation of New  
Basel Capital Accord  
68 FR 148 (August 4, 2003)**

*Vice President/Treasurer*

**DAVID F. WILSON**  
WILSON CONSTRUCTION, LLC  
Ketchum, ID  
(208) 726-9776  
FAX: (208) 726-1419  
E-MAIL: dfwilson@sunvalley.net

Dear Ms. Johnson:

On behalf of the 211,000 member firms of the National Association of Home Builders (NAHB), I welcome the opportunity to respond to the Advance Notice of Proposed Rulemaking (ANPR) issued jointly by the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC) and the Office of Thrift Supervision (OTS) (collectively, "the Agencies"). The ANPR sets forth the Agencies' views on a proposed framework for implementing the new Basel Capital Accord (Basel II) in the United States. NAHB is a national trade association representing individuals and companies involved in the production of housing and related activities. Each year, NAHB's builder members construct about 80 percent of all new housing in America.

*Vice President/Secretary*

**DAVID L. PRESSLY, JR.**  
PRESSLY DEVELOPMENT COMPANY, INC.  
Statesville, NC  
(704) 872-1000  
FAX: (704) 878-2217  
E-MAIL: dpressly@statesville.net

The Basel Capital Accord is an internationally agreed upon framework for measuring and determining the capital requirements for financial institutions. Over the past several years, the Basel Committee on Banking Supervision (Basel Committee) aided by the involvement of the Agencies, has been attempting to incorporate advances in risk measurement and management practices, and refine the procedures used to assess capital charges in relation to risk. In April 2003, the Basel Committee issued its third Consultative Paper (CP3) to seek comments on the latest proposed version of Basel II. In turn, the Agencies' ANPR seeks comment on how Basel II, as specified in CP3, would be implemented in the United States.

*Immediate Past President*

**F. GARY GARCZYNSKI**  
NATIONAL CAPITAL LAND  
& DEVELOPMENT, CO.  
Woodbridge, VA  
(703) 580-8419  
FAX: (703) 580-8230  
E-MAIL: ggarczynski@nahbofficer.com

*Executive Vice President &  
Chief Executive Officer*

**GERALD M. HOWARD**  
Washington, DC  
(202) 266-8257  
FAX: (202) 266-8349  
E-MAIL: jhoward@nahb.com

NAHB notes that while some aspects of Basel II may represent an improvement over current capital regulations, revisions to the Basel Capital Accord could unnecessarily impact the cost and availability of housing production loans from insured depository institutions. NAHB's comments focus on these possible adverse consequences and offer recommendations to avoid such outcomes. Our comments also address Basel II's potential adverse impact on affordable housing and the competitive environment for smaller banking institutions.

### **Treatment of Residential Acquisition, Development and Construction Loans**

Under the current regulations for U.S. financial institutions, most housing production or residential land acquisition, development and construction (AD&C) loans require a capital backing of 8 percent. This is the standard requirement for most loans and investments on U.S. financial institution balance sheets. One notable exception is the capital treatment of construction loans on pre-sold single family homes, which currently have a 4 percent capital requirement, giving these loans the same preferred capital standing as home mortgages. This approach would be altered dramatically under the capital framework proposed by the Basel Committee in CP3.

In CP3, Basel II would provide two methodologies for determining capital requirements for credit risk exposures; the standardized approach and the internal ratings-based (IRB) approach. Under the standardized approach, financial institutions would be required to slot their credit exposures into a series of risk categories; each category would have a fixed risk weight assigned by the Agencies. In the IRB approach, an institution would be permitted to use its own internal estimates of key risk drivers to derive capital requirements. Within the IRB approach there is a foundation methodology, in which the institution and its supervisor provide inputs regarding certain risk components, and an advanced methodology (A-IRB), where institutions themselves provide more risk inputs.

In the ANPR, the Agencies are proposing that large, internationally active banking organizations will be required to use Basel II's A-IRB approach for determining capital requirements for credit risk exposure. Generally, financial institutions using the A-IRB approach would assign assets and off-balance-sheet exposures into one of three credit exposure portfolios: Wholesale, Retail and Equities. The three credit exposure portfolios are subdivided into a series of risk classes, which are further striated into risk subcategories.

NAHB's concerns primarily address the Wholesale portfolio risk class identified in Basel II and the ANPR as Corporate Exposures. Basel II groups both residential and commercial AD&C loans into the Commercial Real Estate (CRE) subcategory of the Corporate Exposures risk class, with little consideration for the types and risk profiles of the loans. Within the CRE risk class subcategory, loans would be further classified as either low-volatility (IPRE) or high-volatility (HVCRE) assets.

Under the A-IRB approach, an institution's internal assessment of key risk drivers for a particular exposure would serve as the primary inputs in the calculation of the institution's minimum risk-based capital requirements. Formulas, or risk weight functions, specified by supervisors would use the banking organization's estimated inputs to derive a specific dollar amount capital requirement for each exposure. Although the actual dollar amount capital requirement for each exposure has not yet been determined, it appears that the capital burden for residential AD&C loans has the potential of reaching multiples of current requirements.

#### *NAHB Position on CP3*

In a letter submitted to the Basel Committee's request for comments regarding CP3, NAHB expressed concern that Basel II fails to make appropriate distinctions for the highly varied credit risk characteristics of the wide range of assets assigned to the CRE risk class. Moreover, NAHB believes that the Basel Committee has mischaracterized the risks associated with residential AD&C lending activities. The consequence is that Basel II would raise the amount of capital that financial institutions must hold for many residential AD&C loans above current requirements as well as increase capital requirements for all AD&C loans relative to other assets in bank and thrift balance sheets. This treatment could discourage banks from engaging in residential AD&C lending activities because such lending carries the same capital expense as other riskier lending activities. This would result in a significant step backward from the current system, where single family construction loans on pre-sold homes receive the same preferable capital treatment accorded home mortgages, 4 percent, while other residential production loans receive the standard 8 percent capital treatment.

*NAHB Position on ANPR*

In the ANPR, the Agencies generally would place residential AD&C loans in the HVCRE risk category. However, the ANPR provides an exception for loans financing the construction of pre-sold one- to four-family residential properties. Such loans would be eligible to be classified in the IPRE risk category, which is identified as the “low-asset-correlation CRE risk category” in the ANPR. The Agencies also pose a series of questions suggesting that the Agencies are open to considering low-asset-correlation CRE treatment for other classes of residential AD&C loans. For example, the Agencies specifically invite comment on whether all one- to four-family residential construction loans should be included in the low-asset-correlation CRE risk category. The Agencies further request empirical evidence regarding the risk characteristics of AD&C loans.

All Residential AD&C Loans Merit Low-Asset-Correlation CRE Risk Weight Treatment

NAHB appreciates the Agencies’ openness to considering that the risk characteristics of residential AD&C loans are uniquely low vis a vis other CRE loans. Moreover, NAHB enthusiastically supports the Agencies’ determination that construction loans for pre-sold one- to four-family residential properties merit inclusion in the low-asset-correlation CRE risk category. NAHB’s analysis of time-series data from the OTS Thrift Financial Report shows that the charge-off rates for residential housing production loans are dramatically lower than for nonresidential real estate loans. In fact, the performance of single family home construction loans has been very close to the experience for home mortgages. We have attached a series of charts and a table with the underlying data that demonstrate the performance of residential AD&C loans compared to other asset categories.

NAHB’s analysis comports with the findings in a white paper published by the Board describing the Board’s analysis of the loss characteristics of commercial real estate loan portfolios of U.S. financial institutions. The white paper notes that some key features of single family construction loans (i.e., high proportion of pre-sales and substantial borrower equity) could be positive factors resulting in lower capital requirements for such loans. Further, the Board’s analysis suggests that the asset correlation for single-family construction loans may be smaller than the asset correlation for other construction loans. Accordingly, the Board’s inclination in the white paper is that single family loans should be classified as having low rather than high asset

correlation. Specifically, the white paper states "... the available evidence suggests that perhaps these loans should be classified as having low (IPRE) rather than high (HVCRE) asset correlation."

The Board's white paper also indicates that the short maturity of a loan is another risk mitigating factor that would justify a low volatility risk weight for residential AD&C loans. NAHB notes that the vast majority of residential AD&C loans have maturities that fall well below the 2.5 years cited in the white paper as a benchmark for incurring a low-volatility risk weight.

Given the empirical evidence presented in both NAHB's and the Board's analyses, NAHB believes that the increased capital requirements for residential AD&C loans that would result from a strict application of Basel II are unwarranted, and that all residential AD&C loans should be classified in the low-asset-correlation category for CRE loans. We urge the Agencies to request that the Basel Committee incorporate this approach into the final version of Basel II.

#### Additional Capital Preferences for Risk Mitigation Techniques

The ANPR asks whether additional preference should be accorded residential AD&C loans if they meet other risk-minimizing criteria such as substantial equity or pre-sales arrangements. NAHB notes that the Agencies' current risk-based capital standards include these factors as a rationale for assigning a risk weight that is 50 percent lower than the standard risk weight. Under the Agencies' current risk-based capital standards, pre-sold residential properties are eligible for a 50 percent risk weight if certain criteria are met. The criteria, summarized below, are designed to minimize the risks associated with such loans:

- The builder must incur at least the first 10 percent of the direct costs (*i.e.*, actual costs of the land, labor, and material) before any drawdown is made under the construction loan.
- The construction loan must not exceed 80 percent of the sales price of the resold home.
- The home buyer must make a substantial "earnest money deposit."
- The lending institution must obtain sufficient documentation demonstrating that the buyer of the home intends to purchase the home. (In some cases, the Agencies require a legally binding written sales contract.)

- The lending institution must obtain sufficient documentation that the home buyer has the ability to obtain a mortgage loan sufficient to purchase the home. (In some cases, the Agencies require a firm written commitment for permanent financing of the home upon completion.)

NAHB believes the risk-minimizing criteria specified in the current interagency risk-based capital standards should be extended to single family construction loans in Basel II and, in addition, are readily adaptable to other types of residential construction loans and residential lot sales. For example, NAHB requests that the Agencies permit residential land development loans to qualify for low-asset correlation capital treatment if:

- The developer has incurred at least the first 10 percent of the direct costs (*i.e.*, actual costs of the land, labor, and material) before any drawdown is made under the land development loan, and
- The development loan does not exceed 75 percent of the cost of development.
- The buyer of the developed land must make a substantial “earnest money deposit.”
- The lending institution must obtain sufficient documentation demonstrating that the buyer of the developed land intends to purchase the land.
- The lending institution must obtain sufficient documentation that the buyer of the developed land has the ability to obtain a loan sufficient to purchase the developed land.

The Agencies also request comment regarding how to interpret the “pre-sold” exception in cases where loans finance the construction of a subdivision or other group of houses, some of which are pre-sold while others are not. NAHB believes that the interagency risk-based capital standards criteria can also be applied in these situations with minimal modifications. For example, NAHB requests that the Agencies permit loans to finance the construction of a subdivision or other group of houses to qualify for low-asset correlation capital treatment if:

- The builder has incurred at least the first 10 percent of the direct costs (*i.e.*, actual costs of the land, labor, and material) before any drawdown is made under the construction loan, and
- The construction loan does not exceed 80 percent of the cost of all residences to be constructed, and
- For at least 75 percent of the residences:

- The home buyer has made a substantial “earnest money deposit;”
- The lending institution has obtained sufficient documentation demonstrating that the buyer of the home intends to purchase the home, and
- The lending institution has obtained sufficient documentation that the home buyer has the ability to obtain a mortgage loan sufficient to purchase the home.

### **Impact on Affordable Housing**

NAHB also requests that the Agencies address an apparent conflict in the ANPR’s treatment of equity investments in affordable housing programs and other housing tax credit investments. Under the ANPR, an institution using the A-IRB approach for determining capital requirements for credit risk exposure would also be required to use the A-IRB approach if its equity exposure is “material.” The ANPR excludes from the A-IRB capital charge treatment certain equity exposures made under legislated programs that involve government oversight and restrictions on the types or amounts of investments that may be made (legislated program equity exposures). This legislated program equity exposure exclusion would apply to public welfare investments made by financial institutions to satisfy their Community Reinvestment Act (CRA) obligations. Such public welfare investments include investments in affordable housing and low income housing tax credits. According to the ANPR, legislated program equity exposures would receive a risk weight of 100 percent. NAHB supports this treatment because it promotes important public welfare goals and because it recognizes the investment’s unique risk and return characteristics (i.e. compared to other equity investments, CRA equity investments may sometimes provide lower yields but they also may have lower default rates and are less volatile.)

A conflict arises, however, because the ANPR includes legislated program equity exposures in the test to determine whether an institution’s equity exposure is “material.” Under this test, when the financial institution’s total equity holdings, including CRA-related investments, exceed 10 percent of Tier 1 plus Tier 2 capital, the bank must set aside higher amounts of capital for non-CRA-related investments. NAHB is concerned that including CRE-related investments in the materiality test could cause financial institutions to minimize investments in low yielding, less liquid CRE equity investments, to avoid triggering the much higher capital charges on, and thus reducing the profitability of, non-CRA investments. The result

could be a reduction in new investment in housing and other projects designed to meet the needs of underserved communities.

We therefore urge the Agencies to remove CRA-related investments from the proposed materiality test for determining capital requirements for other equity exposures.

### **Competitive Impact of Basel II**

NAHB is also concerned about the potential adverse effect of Basel II on the competitive position of smaller financial institutions. Small banks will be exempted from Basel II under the implementation plan proposed by U.S. financial institution regulators. Moreover, due to the daunting level of resources necessary to develop and implement a Basel II-compliant risk management system, smaller financial institutions are unlikely to opt in to Basel II. As a result, smaller institutions could find themselves at a competitive disadvantage to larger institutions whose capital costs will likely be reduced under Basel II. This situation raises serious concerns about the long-term viability of smaller community banks and thrifts. These institutions are an integral component to the infrastructure of communities throughout the U.S., and they are a critical source of funding for consumers and commercial enterprises alike. The majority of NAHB's builder members are small businesses that obtain financing from community banks and thrifts. In fact, community-based financial institutions account for the bulk of residential AD&C lending. We urge the Agencies to consider the consequences that would result if Basel II were implemented without rectifying the fundamental bias against smaller financial institutions.

NAHB is encouraged that the Agencies' intend to conduct another Quantitative Impact Study, and potentially other economic impact analyses, to better understand the impact of the proposed framework not only on individual U.S. financial institutions but on the U.S. financial services industry overall. NAHB takes further comfort in the Agencies' commitment, expressed in the ANPR, that "If competitive effects of the New Accord are determined to be significant, the Agencies would need to consider potential ways to address those effects while continuing to seek to achieve the objectives of the current proposal."



**Conclusion**

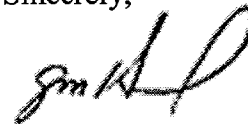
NAHB endorses the Agencies' conceptual approach to establish greater risk-sensitive detail within Basel II's Commercial Real Estate (CRE) sub-category, as it is implemented in the U.S. In this regard, NAHB urges that all residential AD&C loans be reclassified as low-volatility (low-asset-correlation) assets. Moreover, we request that due consideration be given to factors that could be used to assign additional preferential risk weights to such loans (i.e. substantial equity and high proportion of pre-sales).

NAHB further requests that the Agencies revise the materiality test for determining whether a financial institution must use the A-IRB approach for calculating its equity exposure capital charge. As discussed above, the revisions should correct the ANPR's potential disincentive for making affordable housing investments.

NAHB also stands ready to work with the Agencies to explore the various options that may be available to implement the Basel Capital Accord in the United States in a manner that does not create competitive inequities.

Thank you for your consideration and we invite you to call on us if we can provide additional information.

Sincerely,



Gerald M. Howard  
Executive Vice President and  
Chief Executive Officer

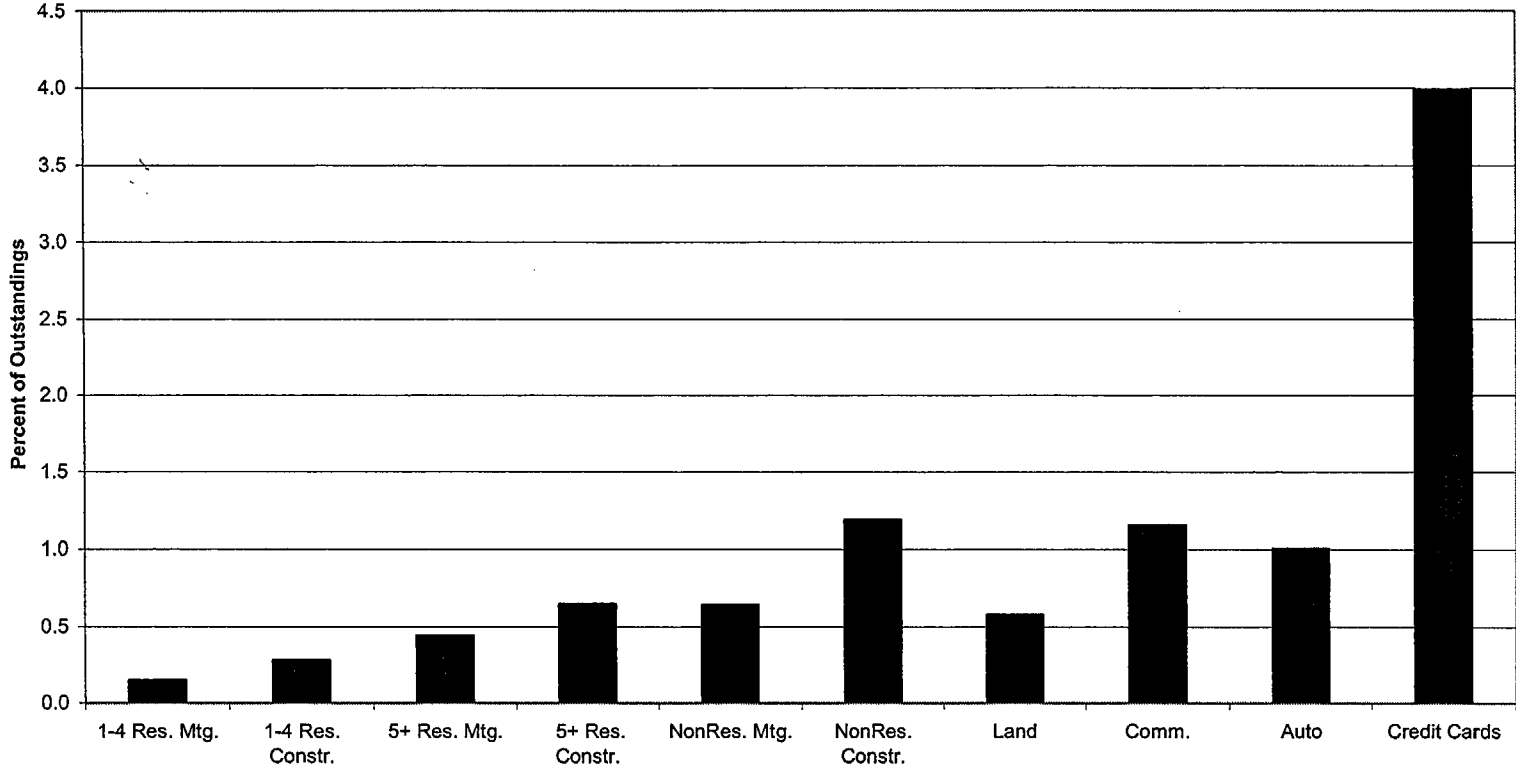
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Acquisition, Development and Construction (AD&C) Loan  
Performance Data

Compiled by:  
Housing & Finance Policy Area  
National Association of Home Builders

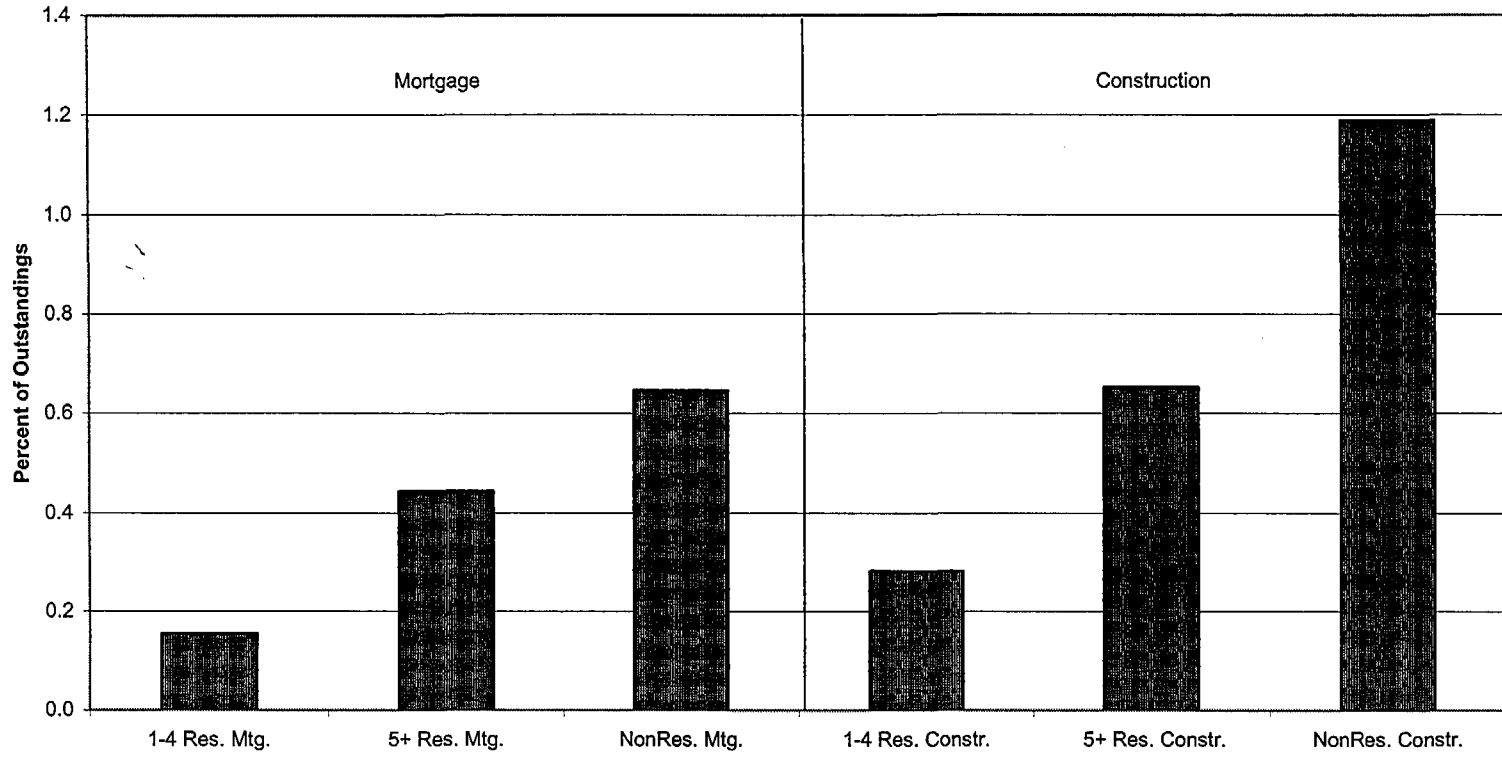


**Comparison of Net Chargeoff Rates by Loan Type for All OTS Thrifts**  
 Annual Averages, 1990-2002



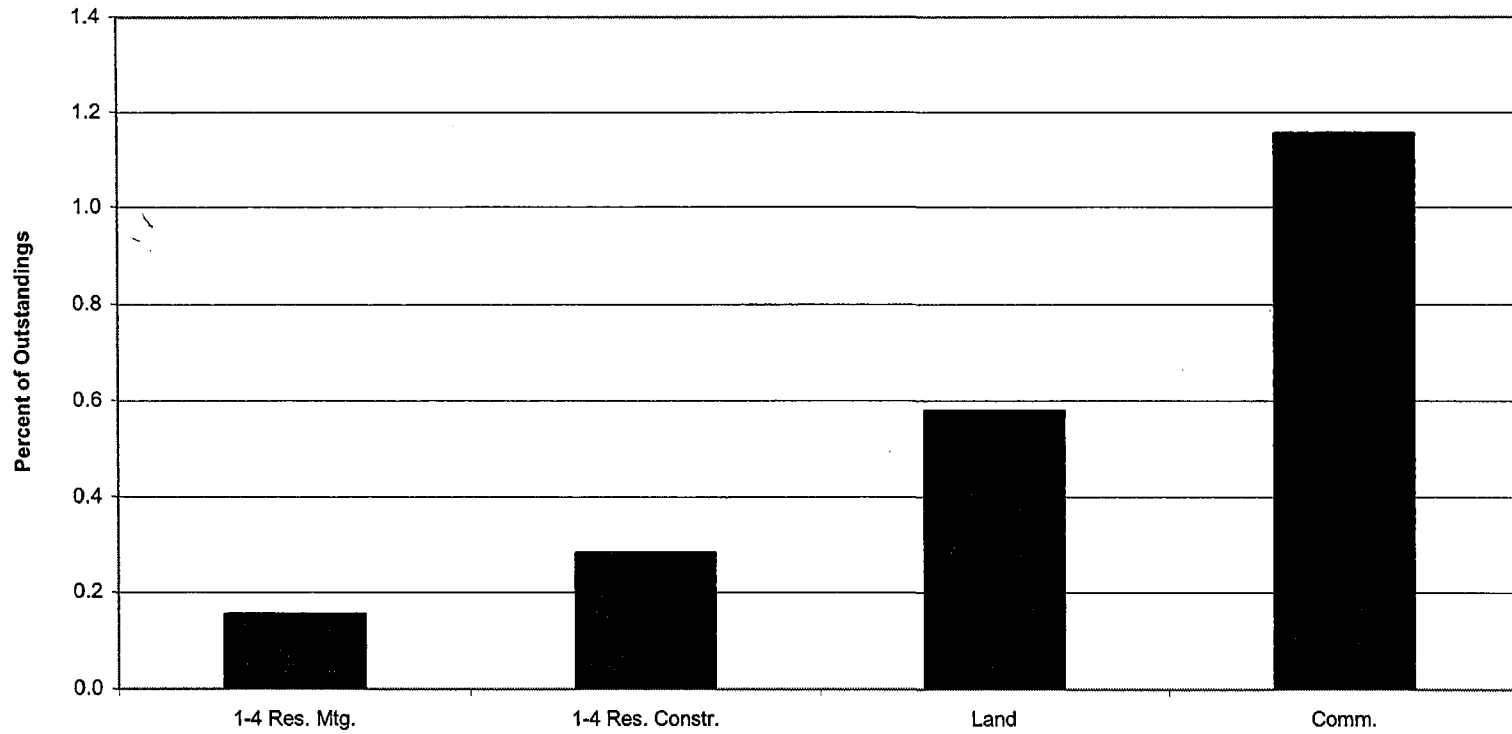
Savings and Loan Net Chargeoffs as Percent of Average Outstanding Loans  
 Source: Office of Thrift Supervision, Compiled by NAHB

**Comparison of Mortgage and Construction Loan Net Chargeoff Rates**  
 Annual Averages, 1990-2002



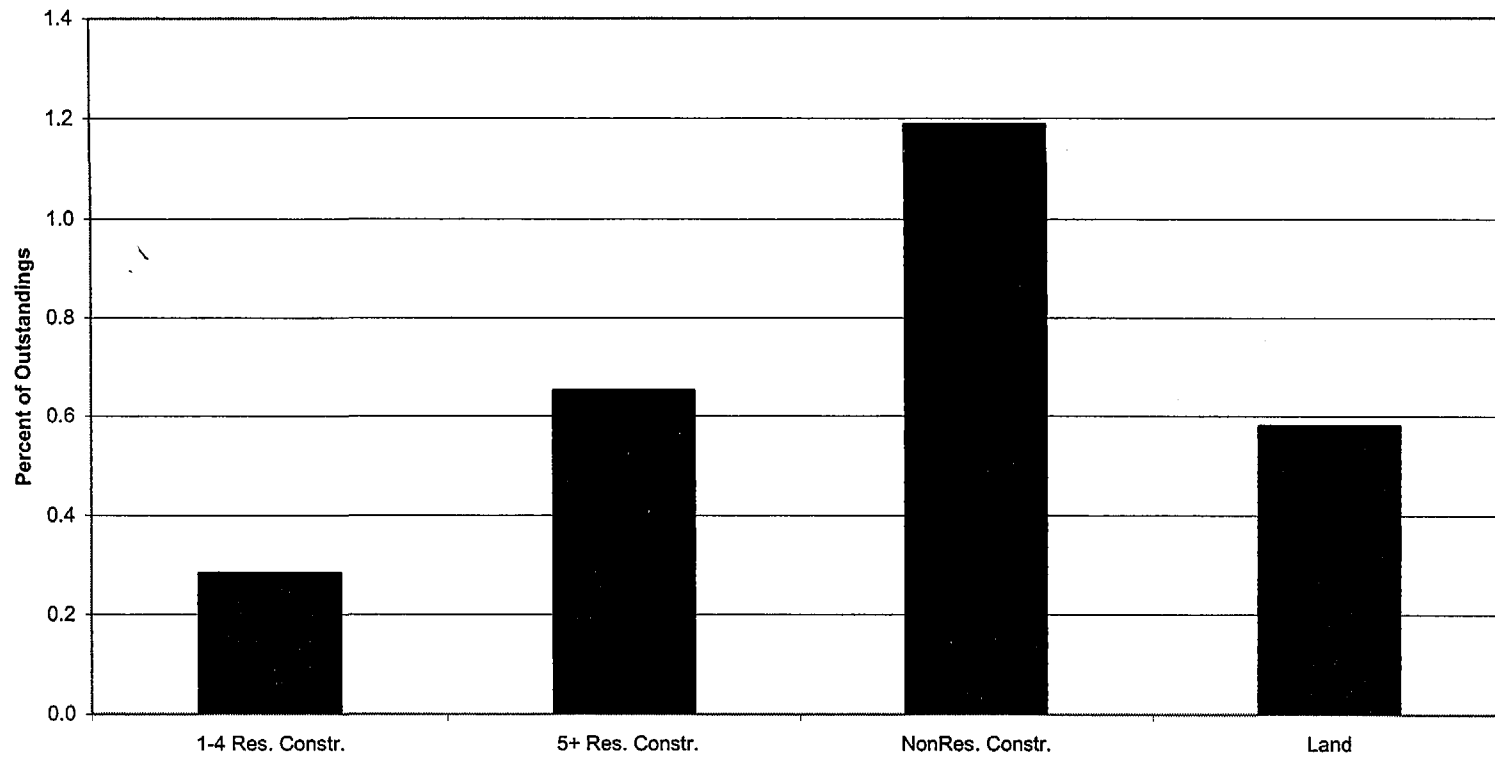
Savings and Loan Net Chargeoffs as Percent of Average Outstanding Loans  
 Source: Office of Thrift Supervision, Compiled by NAHB

**Home Mortgage and Construction Loan Performance  
Compared to Land and Commercial Loans  
Annual Averages, 1990-2002**



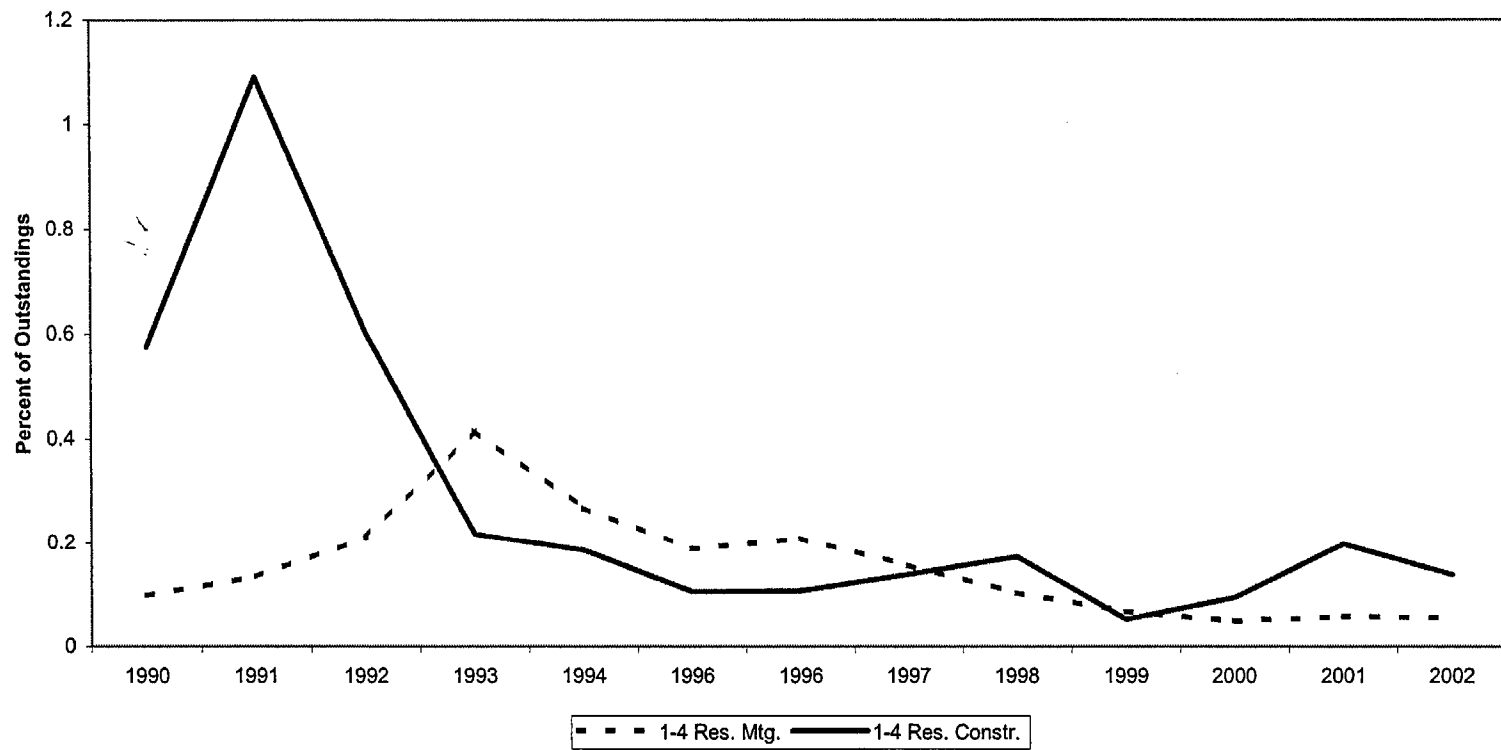
Savings and Loan Net Chargeoffs as Percent of Average Outstanding Loans  
Source: Office of Thrift Supervision, Compiled by NAHB

**Comparison of Construction and Land Loan Net Chargeoff Rates**  
Annual Averages, 1990-2002



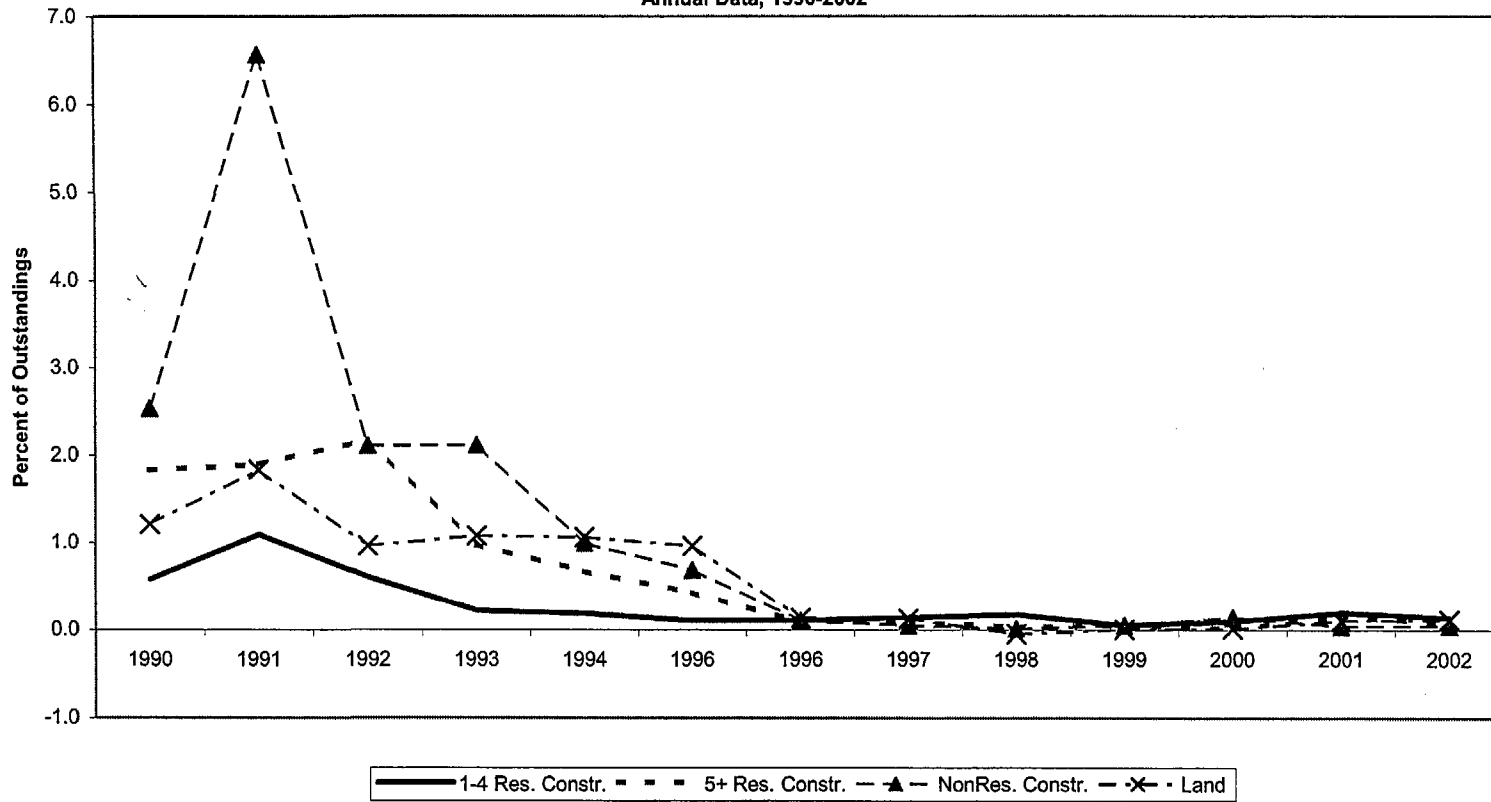
Savings and Loan Net Chargeoffs as Percent of Average Outstanding Loans  
Source: Office of Thrift Supervision, Compiled by NAHB

**Home Mortgage and Construction Loan Performance**  
**Savings and Loan Net Chargeoffs as Percent of Average Outstanding Loans**  
**Annual Data, 1990-2002**



Source: Office of Thrift Supervision, Compiled by NAHB

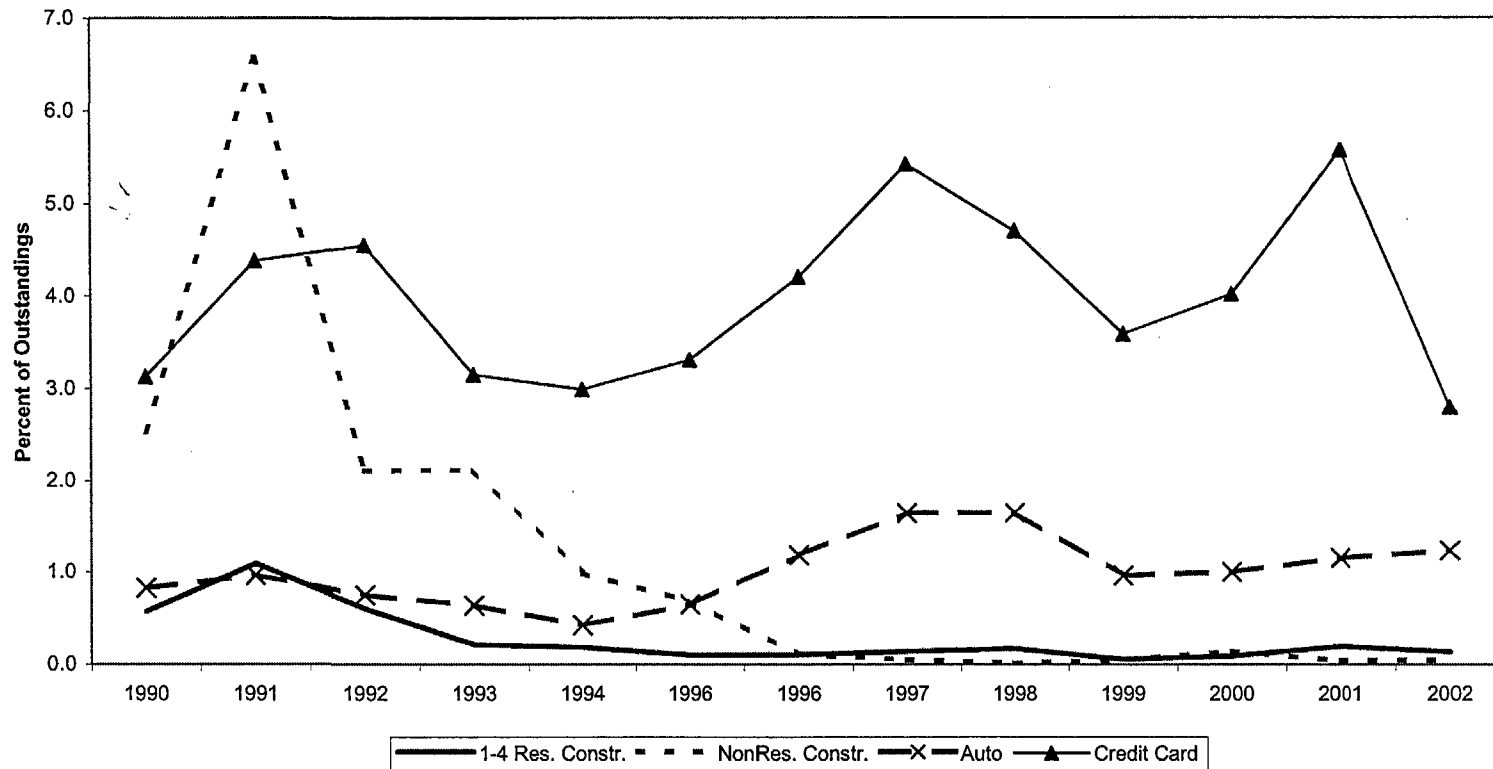
**Comparison of Construction and Land Loan Net Chargeoff Rates**  
**Savings and Loan Net Chargeoffs as Percent of Average Outstanding Loans**  
**Annual Data, 1990-2002**



Source: Office of Thrift Supervision, Compiled by NAHB



**Performance of Home Construction Loans Relative to Other Loan Types**  
**Savings and Loan Net Chargeoffs as Percent of Average Outstanding Loans**  
**Annual Data, 1990-2002**



Source: Office of Thrift Supervision, Compiled by NAHB

Net Chargeoffs as Percent of Average Loan Amount - By Loan Type for all OTS Thrifts

Annualized from Quarterly Data										
Year	Percent of 1-4 Res. Mtg. Mtg. Loans	Percent of 1-4 Res. Construction Loans	Percent of 5+ Res. Mtg. Mtg. Loans	Percent of 5+ Res. Constr. Loans	Percent of NonRes. Mtg. Mtg. Loans	Percent of NonRes. Constr. Constr. Loans	Percent of Land Loans	Percent of Comm. Loans	Percent of Auto Loans	Percent of Credit Card Loans
1990	0.098	0.575	0.835	1.829	1.389	2.533	1.208	1.310	0.829	3.131
1991	0.135	1.091	0.610	1.898	1.166	6.574	1.836	2.190	0.963	4.386
1992	0.211	0.603	0.724	2.176	1.321	2.110	0.960	1.455	0.751	4.554
1993	0.416	0.217	0.844	0.971	1.629	2.119	1.076	3.067	0.641	3.154
1994	0.268	0.186	1.446	0.667	1.168	0.989	1.059	0.902	0.426	2.993
1996	0.188	0.105	0.644	0.427	0.781	0.684	0.959	0.674	0.651	3.312
1996	0.209	0.107	0.524	0.088	0.392	0.106	0.135	0.314	1.185	4.212
1997	0.156	0.139	0.183	0.098	0.084	0.052	0.126	0.382	1.646	5.424
1998	0.103	0.173	0.068	0.032	0.087	0.014	-0.045	0.447	1.648	4.711
1999	0.067	0.052	-0.069	0.053	0.042	0.052	0.006	0.473	0.964	3.592
2000	0.049	0.094	-0.033	0.013	0.040	0.141	0.012	0.946	1.004	4.024
2001	0.057	0.198	0.001	0.155	0.188	0.040	0.100	1.348	1.155	5.575
2002	0.055	0.138	0.000	0.073	0.111	0.049	0.114	1.536	1.239	2.803
Average	0.155	0.283	0.444	0.652	0.646	1.189	0.580	1.157	1.008	3.990