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The Real Estate Roundtable

January 12, 2024

Chief Counsel's Office
Attention: Comment Processing
Office of the Comptroller of the Currency
400 7th Street, SW
Suite 3E–218
Washington, DC 20219

Ms. Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Mr. James P. Sheesley
Assistant Executive Secretary
Attention: Comments/Legal OES (RIN 3064–AF29)
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Re: Notice of Proposed Rulemaking for Amendments to the Regulatory Capital Rule (Docket ID OCC–2023–0008, Docket No. R-1813)

Ladies and Gentlemen:

We are pleased to provide comments on the proposed Basel III Endgame rulemaking by the Office of the Comptroller of the Currency, Federal Reserve System, and Federal Deposit Insurance Corporation (the "Agencies").

We support the Agencies' efforts to ensure the safety and soundness of the banking system through an appropriately calibrated regulatory framework. However, we believe that the proposed Basel III *Endgame* rulemaking would have harmful effects on real estate capital markets activities and on the availability and cost of credit to commercial and multifamily real estate borrowers and on the U.S. economy in general. Given the credit challenges currently facing real estate borrowers and investors, the fragile nature of the economy, and the continued volatility in credit and capital markets, we strongly believe that further study and analysis is necessary to appropriately craft the proposed rules to ensure a properly functioning and reliable credit market. For this reason, we recommend that the proposed rule be withdrawn and only reissued after further study.

The potential significant increase in capital requirements for large banks' capital market activities due to the Basel III *Endgame* could materially reduce the depth of banks' products and services offerings to the real estate sector, which will in turn lead to increased cost of raising capital and hedging risk for the industry. As a result, we anticipate that the real estate industry could encounter difficulties in their access to liquidity and affordable funding to fuel growth and create jobs.

The largest U.S. banks' capital and liquidity levels have grown dramatically since the original Basel III standards were implemented in 2013 in response to the 2008 Global Financial Crisis. Since 2009, Tier 1 capital has increased by 56 percent and Common Equity Tier 1 capital has tripled. Today, as the Federal Reserve recently observed, the U.S. "banking system is sound and resilient, with strong capital and liquidity."[1] Under the Basel III Endgame proposal, Tier 1 capital will increase by another 16% and Common Equity Tier 1 capital is projected to go up by nearly $200 billion.

While well-intentioned, we are concerned that the proposal could increase the cost of credit, diminish lending capacity and undermine the essential role banks play in lending and financial intermediation for real estate. The proposed increases in capital requirements come at a significant economic cost without clear benefits to the resiliency of the financial system. Not only is the imposition of a punitive capital charge unjustified at this time, regulators have failed to provide justification for such an increase. So, it is not clear what problem regulators are trying to solve with this proposed capital hike.

It is important to maintain credit capacity in the $5.67 trillion commercial real estate debt[2] markets, some 50.3 percent of which is held by commercial banks. Smaller banks hold approximately $2.3 trillion in commercial real estate debt.[3] Raising capital levels at the largest U.S. banks will only limit credit and feed a downward spiral that will put additional pressure on the financial system.

Of that outstanding debt, approximately $2.75 trillion of commercial real estate loans are maturing over the next four years. The bulk of these loans were financed when base rates were near zero. They now need to be refinanced in an environment where rates are much higher, values are much lower and in illiquid markets. The delinquency rate on CRE loans held by U.S. banks, which is a lagging indicator, was modest at 0.81 percent in the second quarter of 2023, but it is up from 0.74 percent in the second quarter of 2022.[4]

Adding to market uncertainty, deposits at small U.S. banks—the dominant lenders to CRE—have decreased by nearly $250 billion since January 2023. This pressure will likely lead to a pullback in lending among some banks, including to the CRE market, reinforcing existing headwinds on the sector.

Overall lending to commercial real estate is already diminished, including the new issuance of commercial mortgage-backed securities (CMBS). The supply of conduit CMBS is down by 72 percent in the year to date compared with the same period in 2022. Single-asset/single-borrower CMBS have fallen by 85 percent and CRE collateralized loan obligations are down by 92 percent.[2]

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[1] [1] https://www.federalreserve.gov/publications/files/svb-review-20230428.pdf
[2] Federal Reserve, Trepp.
[3] Trepp data cited in the *Wall Street Journal*
[4] Financial Stability Oversight Council, Annual Report 2023, Federal Deposit Insurance Corporation data.

Securitization

Securitization markets – particularly CMBS – are a key credit source for commercial real estate markets. Punitive changes in the proposed securitization capital framework will increase the cost and diminish the availability of credit for commercial real estate.

Compared to the current simplified supervisory formula approach ("SSFA"), the proposed securitization standardized approach ("SEC-SA") would, among other things, (1) require a higher supervisory parameter *p* factor for securitization exposures that are not re-securitizations (1 vs. 0.5) and (2) modify the definition of the W parameter on "delinquency".

These changes generally have the effect of increasing the capital charges associated with securitizations. However, the Agencies have not identified any increased risk from securitizations justifying this increase. On the contrary, the many post-2008 crisis reforms relating to securitization and mortgages, such as the credit risk retention rule, have reduced the credit risk associated with securitizations. There is therefore no reason to increase the capital charges stemming from the securitization framework. The below changes to the SEC-SA should be made to significantly improve the calibration and risk sensitivity of the SEC-SA.

First, the Agencies should revert to a 0.5 *p* factor. Increasing the *p* parameter from 0.5 to 1 is not necessary to produce sufficiently conservative capital requirements. The changes the Agencies cite to justify this increase (reduced risk weights applicable to certain underlying assets that would be reflected in lower values of K_G and the proposed reduction in the risk-weight floor under SEC-SA for securitization exposures that are not re-securitization exposures) are still sufficiently conservative. The Agencies have not conducted their own review of the impact of the SEC-SA, which should in particular evaluate the total effect of the proposed changes to retail exposures and to the securitization framework on the RWAs for consumer securitization exposures as compared to other jurisdictions. A 0.5 *p* factor is therefore appropriate to mitigate unintended consequences.

Second, the Agencies should provide that exposures that are modified and become re-performing may be excluded from the W parameter. As described in Section 133(b)(1) of the proposal, the W parameter is the ratio of the outstanding amount of exposures that are not performing, delinquent or in default to the outstanding amount of all the exposures underlying the securitization. The W parameter would include underlying exposures that, for example, are 90 days or more past due, have contractually deferred payments for 90 days or more or are in default, but the proposal does not provide for those exposures to be removed from the calculation if the exposures are modified and re-perform.

So it is important for the Agencies to recalibrate their proposal accordingly to avert increased borrowing costs and reduced credit capacity for real estate and the overall economy.

Capital Formation Essential

In addition to the proposed capital increases for banks, the Securities and Exchange Commission (SEC) has a number of proposed rulemaking measures that could have a chilling effect on commercial real estate capital markets. The Agencies should be mindful on how all these regulations interact. Capital formation is vital when credit markets tighten to help restructure maturing debt.

Commercial real estate (CRE) industry is a roughly $20 trillion dollar market comprised of a variety of income producing property types – apartment, office, retail, industrial, hotel, senior, student, and manufactured housing as well as medical offices, life science campuses, data centers, cell towers, and self-storage properties.

Commercial real estate (CRE), the third-largest asset class after fixed income and equities, is under pressure. An aggressive rate tightening cycle by the Federal Reserve and other major central banks over the past year has fueled concerns about the potential impact on the sector, given its reliance on debt and bank financing. This has been compounded by the prospect of further tightening in credit conditions resulting from recent stress among U.S. regional banks, which are a key source of lending to the sector.

Addressing the Wave of Commercial Real Estate Maturities

As requested in The Real Estate Roundtable's March 17, 2023[5] letter, the June 30, 2023 *Policy Statement on Prudent Commercial Real Estate Loan Accommodations and Workouts* is helping to encourage financial institutions to work constructively with creditworthy borrowers on CRE loan workouts to see loans through the current environment. According to a recent Trepp research report, some $5.65 billion in commercial real estate loans have already been restructured this year. We commend the Agencies for recognizing that prudent loan workouts are often in the best interest of both financial institutions and borrowers, particularly during difficult economic conditions.

Yet, despite this constructive policy statement, the Basel III *Endgame* proposal would change how a defaulted mortgage is defined, including exposure to the borrower. Most commercial real estate lending is structured on a non-recourse basis, permitting the lender to seize only the collateral specified in the loan agreement, even if its value does not cover the entire debt. However, under the Basel III Endgame proposal, the bank must analyze overall exposure to the borrower, beyond the specific loan. The proposed rule would assign a 150% risk weight to any defaulted loan and essentially all other loans to the same borrower (even if current). As such, it raises concerns about maintaining the integrity of non-recourse lending agreements.

Instead, regulators should focus on additional measures to help restructure and transition the ownership and financing of commercial real estate from a period of low rates and robust markets to a time of higher rates, declining credit capacity and uncertain economic growth.

The credit quality of commercial real estate loans today is stronger than in the period preceding the savings and loan crisis of the 1980s and 1990s, and the global financial crisis of 2007-2008. For over a decade, with interest rates close or at zero, loans were conservatively underwritten, with strong debt service coverage and low loan to values.

Many loans that will mature in the next few years were originated at loan-to-value levels of 50 percent to 65 percent. This significant equity cushion suggests that the impact of lower valuations will be mostly felt by equity sponsors rather than holders of CRE debt including banks, insurers and investors in CMBS.

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[5] Roundtable Urges Federal Bank Regulators to Reestablish CRE Troubled Debt Restructuring Program, March 17, 2023, https://www.rer.org/policy-issues/policy-comment-letters/detail/roundtable-urges-federal-bank-regulators-to-reestablish-cre-troubled-debt-restructuring-program

As the Fed has increased rates to fight inflation, we are now in an entirely different environment. Liquidity has contracted, and values have declined. Many of these loans will require additional equity, and borrowers will need time to restructure this debt. Capital formation is increasingly important to avoid broader economic impact.

The U.S. commercial real estate market is comprised of many diverse regional and local markets, as well as submarkets within markets, each with their own dynamics. A common attribute through all, however, is that they each depend on a healthy economy for occupancy and operating income, and on a liquid financing market to facilitate investment, development and transfer. And, it is important to remember that over 70 percent of local tax revenues[6] and more than a third of all the money used to finance public education comes from real estate[7].

At this critical time, it is imperative that policymakers and regulators do not engage in pro-cyclical policies such as requiring financial institutions to increase capital and liquidity levels to reflect current mark to market models. These policies would have the unintended consequence of further diminishing liquidity and creating additional downward pressure on asset values. A deflationary spiral must be avoided at all costs. As recent events are only amplifying the contraction of credit, it is important for the regulatory Agencies to take measures to maintain sufficient liquidity levels and support positive economic activity.

These realities require time as well as a significant improvement in current market stability. Moreover, given the recent turmoil experienced in some regional banks, which is largely unrelated to commercial real estate exposures, we anticipate that liquidity will tighten further and lending options for refinancing maturing loans will decrease.

Moreover, it is hard to overstate the negative impact on current and future multifamily development construction loans intended to help address our country's housing shortage. These loans are typically floating rate, causing many current loan financing rates to more than double and likely halting significant amounts of future housing construction financing.

There also is the potential for high negative impact to the owners of commercial real estate – investors including universities and pension funds for teachers, unions, and others.

Conclusion

We understand and appreciate the goals that the Agencies are trying to achieve, but we have serious concerns about the impact the proposed rules will have on the commercial and multifamily real estate market, commercial real estate credit flows, and the overall economy. Based on prior experience with material changes to capital rules, compliance efforts among affected institutions will set the tone for lending across the broader banking industry. Such broad market impact points to the importance of ensuring that the final rule is appropriately calibrated.

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[6] Tax Foundation, To What Extent Does Your State Rely on Property Taxes? (2021), https://taxfoundation.org/data/all/state/state-property-tax-reliance-2020/.

[7] Lincoln Institute of Land Policy & Minnesota Center for Fiscal Excellence, 50-State Property Tax Comparison Study at pg. 3 (June 2021).

The Agencies should exercise caution with the imposition of pro-cyclical measures that could further diminish credit capacity and weaken economic conditions. The wave of commercial real estate debt maturities and demand for new construction – particularly for affordable multifamily housing – is already testing capacity levels.

We are concerned that the significant increases in capital requirements, as proposed under the Basel III *Endgame*, will result in material costs to real estate credit and capital markets, and the broader economy that will not be outweighed by any marginal financial stability benefits. Regulators should therefore carefully weigh the costs and benefits of these capital reforms to ensure that they achieve an appropriate balance between financial stability and broader economic growth.

Given the credit challenges facing commercial real estate, the fragile nature of the economy, and the continued volatility in credit and capital markets, it is important to appropriately craft changes to the existing risk-based capital framework to ensure a properly functioning and reliable credit market. Given the broad range of concerns among various industry participants regarding the proposed risk-based capital rules, we urge the to carefully study the impact of any proposed rules on the economy and to carefully calibrate risk weights with the actual risk of an asset.

We, therefore, request that the Agencies re-propose the rule with the benefit of the results from their economic study and allow public comment period prior to issuing a final rule. These additional steps are necessary to further refine changes to the existing risk-based capital framework and reduce the potential for unintended negative effects on the real estate market and broader economy.

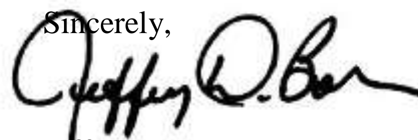
Commercial banks constitute our nation's largest source of commercial real estate financing. Further contraction of bank credit available for commercial real estate could lead to further declines in property values and in the economic condition of existing borrowers. Such a decline would, in turn, reduce the quality of outstanding loans and thus threaten the health of banks that are significantly concentrated in commercial real estate, which would likely lead such banks to further curtail credit.

Unfortunately, we have experienced such vicious cycles in the past and seen the consequences for our economy as a whole. This experience underscores the importance of ensuring that the capital rule is appropriately calibrated; otherwise, the new rule can become a self-fulfilling prophecy, inducing the very same consequences it seeks to prevent.

We trust that the Agencies will find our few comments helpful. Should you have questions or require additional information, please contact Clifton E. Rodgers, Jr., by telephone at (202) 639-8400 or by email at crodgers@rer.org.

Thank you for the opportunity to comment on this important issue.

Sincerely,



Jeffrey D. DeBoer
President and Chief Executive Officer