Basel Rules Target Bank Risk

Pending changes expected to affect commercial mortgage market

By Christina Zausner

Photo illustration by Karen Steichen

The Basel Committee on Banking Supervision (BCBS), a group composed of banking regulators from some 28 countries, is nearing the end of an arduous rule-revamping process. If you are a commercial mortgage broker doing business with a bank, the committee's final regulations on risk-based capital requirements are worth noting because they will likely affect mortgage financing options, particularly with respect to balance-sheet and commercial mortgage-backed security (CMBS) loans.

The BCBS has big plans for revisions to the existing Basel III standards — which were implemented in the U.S. in 2013 and are designed to strengthen the regulation, supervision and risk management of the global banking sector. More revisions, informally known as Basel IV, are in development by the Basel Committee, which hopes to have them ready as soon as the end of this year. They will likely propose vast changes to the risk-based capital-reserve framework and may have material effects for some commercial mortgage products.

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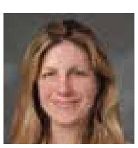

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The BCBS is an international committee empowered by the G-20 nations to establish risk-based capital requirements for banks on a global scale. The committee is comprised of financial supervisors from multiple nations, including the U.S., and is physically located at the Bank for International Settlements in Basel, Switzerland, which served for decades as a key bank supporting global trade.

The U.S. and several other top G-20 nations have dominated a lot of the thinking and rule-making of the Basel Committee. The BCBS can only adopt requirements that pass unanimously. As such, the committee only takes votes when all of its members are in agreement.

After roughly four years of work, the BCBS intended to vote on a broad package of revisions this past January. That vote, however, was postponed and, to date, the body of new rules, often called Basel IV, are in limbo, while the political landscape trends increasingly toward deregulation in many member countries.

At the same time, leadership changes at banking agencies, combined with a deregulatory agenda shared by President Donald Trump's administration and the Republican-controlled Congress, put U.S. adoption of Basel IV in question. This should be a bright note for the banking and mortgage industries in some ways. Yet a U.S. retrenchment on BCBS requirements may come with some hazards, including reprisals against U.S. banks operating in other nations that do adopt the reforms.

Rule adoption

All BCBS requirements are meant to be adopted by U.S. regulators as a condition of participation in the group. But they're not always embraced word for word.

It is expected that BCBS member countries will tailor requirements to fit their own banking systems. Importantly, the home-country requirements are meant to be at least as stringent as those set by the BCBS. In other words, U.S. rules can be more, but not less, restrictive than those set at the international level. This is the so-called "gold-plating" of regulations that you may have read about the past few years.

The U.S. has often imposed more restrictive requirements than the BCBS, both in terms of content and timing. Before final approval in the U.S., rules proposed by agencies must go through a notice and comment process defined in the Administrative Procedure Act (APA). This means the industry has at least one opportunity to provide feedback to regulators on new standards.

Further revisions

As Basel III was implemented around the globe starting in 2013, regulators observed what they deemed to be material variances in capital allocations between banks and geographic regions. In an effort to better align rules in different countries, the BCBS sought to simplify the risk-based capital regime and allow fewer opportunities to diverge from the norm. To carry out this work, the committee established several major work streams that cut across all risk categories (credit, market, operational) and all types of activities (lending, trading, funding, etc.).

The committee has finalized new rules for CMBS, but has yet to adopt them as part of the Basel IV package, a process which could include further revisions to so-called "final requirements." As written, the rules would require banks to use the Standardized Approach (SA). Some U.S. banks currently use an analogous method known as the Simplified Supervisory Fundamental Approach (SSFA).

Most CMBS dealers choose to use Advanced Approaches (AA), which are based entirely on internal models. Banks that have been approved for AA will have to convert to SA, and all banks will have to hold more capital for CMBS and other positions held in their trading books.

When questioned by the industry, regulators explained that even after raising capital requirements on all trading-book activities in the last several years, they believed mortgage-backed securitizations should be supported by even greater capital reserves to offset perceived structural risks. Some analysis suggests the new rules would roughly double the current capital levels for CMBS.

As with CMBS, whole-loan activities at banks would be subject to more standardized methodologies. Loans drawn to financial counterparties, such as private funds, will no longer be allowed to be assessed with AA models, but instead will require application of the more rigid SA model. The decision to apply a common methodology for assessing loans involving financial counterparties was reportedly driven by the belief that those borrowers pose undiagnosed risks.

There also are provisions that realign commercial real estate loans to new risk weights, or levels of importance, under SA. The impact of the new weights are not known, although it's clear the committee has generally looked to raise capital standards as opposed to lowering them.

In addition to new risk weights, the SA and AA methodologies will be subject to capital floors by risk category (with credit risk applying to balance-sheet loans and market risk applying to CMBS) in order to further ensure that, no matter the methodology, risks will not be underestimated.

The High Volatility Commercial Real Estate (HVCRE) rule was included in the Basel III package and implemented in most U.S. banks in 2015. It requires banks to hold in reserve 50 percent more cash on loans that meet the definition of high volatility. U.S. banks and nonbank lending partners are still debating fundamental interpretations of that rule.

Regulators have been open to dialogue and have attempted to assist the industry in working through their questions, but all sides agree additional guidance is warranted. In response, regulators have indicated clarifications to the HVCRE rule will be put through a full APA process and may be integrated into other work, such as the broad Basel IV changes to risk-based capital.

Challenges ahead

Several BCBS members, including Germany and France, have made disparaging statements about Basel IV. While neither

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country has publicly disclosed the aspects they object to in the pending rules, it is widely speculated residential mortgage treatment is one of the most difficult parts for European nations in particular.

To complicate matters, Germany, France and other BCBS members hold national elections this year in which unilateralist talk and deregulation go together. In the meantime, BCBS leaders continue to meet and consider all parts of the proposed requirements, with the hope of finalizing this monumental revision package in the near future.

Working backward from previously stated goals, U.S. regulators hope to have most of Basel IV in place by 2019. That would mean agencies would have to propose rules in 2017, pursue adoption in 2018 and conform by 2019. At the same time, management is turning over at domestic banking regulators:

The seven-seat Federal Reserve Board of Governors as of this past March had two vacancies and Gov. Daniel Tarullo planned to leave this spring, opening a third seat.

The Federal Deposit Insurance Corporation (FDIC) as of the same period had one vacancy and Chairman Martin Gruenberg's term is set to expire in November 2017.
Thomas Curry's term as head of the Office of the Comptroller of the Currency (OCC) was slated to end this past April.

With so many opportunities for leadership change, there also is a chance for a more moderate attitude toward regulation at banking agencies. Timing is of the essence, however, given the possibility of new rules. Many nominees for top regulatory posts must go through a confirmation process as well, which has proven to be more time-consuming under the current U.S. administration than in the past. ■