BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DIVISION OF RESEARCH AND STATISTICS

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To: Myron Kwast

From: Paul Calem and Jim Follain

Subject: Interview with Moody's

These are the comments from the meeting with Moody's on December 10th regarding the competition project. Another memo is being prepared by Paul to summarize a discussion of the treatment of home equity lending.

Moody representatives included: David Fanger; Arlene Isaacs-Lowe, Henry Engelken, and Sean Jones.

1. In Moody's view, the potential for a major shift in the ownership of the credit risk from nonAIRB banks to AIRB banks due to Basel II is modest. The main reason is that the nonAIRB bank holders of whole loans do so to earn the high spread associated with interest rate risk. Since Basel II does not attempt to measure the economic capital associated with interest rate risk, the impact of Basel II should be modest. Furthermore, unbundling the interest rate risk from the credit risk is expensive and would dilute the profits that might be earned from unbundling. This of course assumes that economic capital will be appropriately allocated for interest rate risk, even though there will be no regulatory capital requirements for it. One could argue that the current regulatory capital requirements on mortgages are serving as a proxy for interest rate risk capital requirements.

2. The major investors in the AAA tranches of the RMBS and ABS are insurance companies, pension funds, mutual funds, and governments. Nothing in Basel II will change their likely comparative advantage as the low cost/high price bidders for these tranches.

3. Much of the mortgage debt (1-4 family) on the balance sheets of the banks could be securitized. Much of it is, but even more could be. The fact that it is not highlights the current reasons by banks hold mortgages as noted in #1 above.

4. The main battleground due to Basel II in the mortgage arena may be between the GSEs and the AIRB banks. If so, the nonAIRB banks that originate and sell loans to the GSEs may actually experience a gain in the prices they receive for their loans. More specifically, the heightened competition may lead the GSEs and AIRBs banks to accept lower guarantee fees for their credit insurance and in so doing offer higher mortgage purchase prices to the loan originators. Technically, AIRBs don't really charge g-fees - what they would do is pay higher premiums for mortgages. Also, any such gain for nonAIRB banks would probably be a one-time gain for mortgages already on nonAIRB books. Moody's suspects that much of the lower - fees/higher premiums would ultimately get passed on to the consumer in the form of lower mortgage rates

5. It is difficult to imagine a substantial reduction in mortgage rates due to Basel II. As such, any effect is likely to be a redistribution of ownership of the credit risk (with the possible exception of point #4). Mortgage interest rates are already very low. On the other hand, Moody's did note in a follow-up EMAIL that this view may overstate the case given the recent paper by Passmore