BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DIVISION OF RESEARCH AND STATISTICS

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To: Myron Kwast

From: Jim Follain

Subject: Highlights of Meeting with George Wick of Wells Fargo regarding the Potential Competitive Effects of Basel II on Bank Mortgage Investments

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I met with George Wick of Wells Fargo Bank on November 10th in San Francisco. The purposes were twofold. First, I explained the project underway regarding the potential impact of Basel II on bank investments in mortgages and sought any feedback he wished to offer. Second, I asked some questions designed to clarify some aspects of Wells Fargo's public comments especially related to mortgages. What follows is a brief discussion of a couple of particularly important points that were emphasized during the meeting and in the public comments of Wells Fargo.

1. *All A-IRB banks will not enjoy the same degree of competitive advantage.* Wells actually argues in its comments that it may be disadvantaged relative to the some nonAIRB banks with whom it competes — smaller banks making small business and retail loans. Although there will be benefits to Wells in terms of lower regulatory capital requirements for assets such as small business loans and residential mortgages, Wells believes that the high fixed cost associated with being an AIRB bank may offset some or even all of the advantages. This suggests the potential importance of distinguishing among the AIRB banks as well as types of exposures in any study of competition. Indeed, Wells recommends enlarging the number of AIRB banks to 50 or so and that smaller banks be required to implement the Standardized Basel approach.

2. *Capital rules are conservatively based relative to their internal capital estimates and, as such, lead them to be more binding than Wells would recommend.* They identify a

number of areas in which the rules are conservative, In the area of mortgages, they mention the asset correlation parameter may be too high (Wells Fargo was a contributor to the RMA study, which argues that the asset correlation parameter should be between 6 and 10 percent), although George Wick admits that estimation of the asset correlation parameter is a challenging analytical issue. They also identify the fact that Basel II does not incorporate diversification benefits among various assets whereas their internal models do. This point applies to the overall Basel framework and is not a criticism unique to mortgages.

Our study will likely reference these and other insights offered by Wells Fargo in its public comments.