BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DIVISION OF RESEARCH AND STATISTICS

Date: March 4, 2004

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To: Myron Kwast

From: Paul Calem and Jim Follain

Subject: Report on Visit to Bank of America (B of A) on November 20, 2003

Attendees: Bank of American representatives: Alvaro G de Molina (Treasurer) and John Walters (via phone). Fed of Richmond representatives: Stuart Desch and Perry Mehta. FRB representatives: Paul Calem and Jim Follain. 0CC representatives: Geoffrey White; and Randal Gorman.

Purpose: To seek feedback on the potential competitive affects of Basel II on bank investments in mortgages and amplification of some issues discussed in the official ANPR Comments submitted by the Bank of America.

Perspective: One of world's leading financial services companies. Total assets over $735 billion at the end of 2003:Q3. Income in 2003:Q3 of $2.9 billion. Tier 1 capital ratio of 8.25 percent. $133 billion in residential mortgages and another $22.5 in home equity loans on its balance sheet at the end of 2003: Q3. Innovator of a new mortgage-backed security designed to lay off or take on additional mortgage credit risk - Synthetic Static Arbitrage (RESI 2002-A).

Key Points Discussed Regarding Competition.

1. *The primary effect of Basel II and AIRB status on the competitive landscape is more macro in nature and stems from its potential to: (i) make balance sheet risks more transparent and (ii) provide a type of "accreditation "for banks with "best practice " risk-management systems.*
    a. The regulatory risk based ratio for an AIRB bank will reflect the true risk composition of the bank's portfolio; in B of A's case, the bank will be revealed to be stronger than its current ratio would indicate.
    b. A lower regulatory capital ratio for B of A may contribute to an increase in the rating of its debt. This would be especially valuable in its competition with other large, sophisticated, and internationally active banks, i.e. the other AIRB banks.
    c. AIRB status for B of A will be helpful in signaling to the rating agencies and capital markets its risk management expertise.

2. *AIRB status will not have a major impact upon B of A's broad business strategies and its capital and investment decisions, because regulatory capital generally plays a minor role in this regard.*
   a. B of A currently has more than enough capital to meet regulatory requirement and does not view the current regulatory requirement as a "binding" constraint.
   b. The bank is "comfortable" with its current level of capitalization and will not reduce capital in response to a lower risk-based ratio under Basel II.
   c. Business strategies and investment decisions are driven primarily by internal assessments of return relative to risk. Currently, regulatory capital only comes into play when "all else is equal".
   d. The focus of business strategy and investment decisions is on factors other than regulatory capital, including economic capital, B of A's business expertise, and the behavior of its A1RB competitors. For instance, B of A already has a considerable investment in low-risk fixed-rate conforming mortgages, despite the relatively high regulatory capital charge for under the current Accord.
   e. The role of regulatory capital is dependent upon whether regulatory capital for the entire organization is binding. Indeed, this can vary over a business cycle and as economic conditions change. If regulatory capital is binding at the aggregate level, then the regulatory risk-weights associated with particular types of exposures receive additional consideration.
   f. Under Basel II, interest rate risk will be a constraint on major expansion of the mortgage portfolio—B of A will not have a larger appetite for interest rate risk—but it will be less of a constraint to the extent that it can be unbundled from credit risk.
3. *Micro or secondary effects of Basel II on the mortgage market are possible.* Although a change in its broad business strategy due to Basel II is not planned or anticipated, the substantial reduction in the risk-based capital for residential mortgages may have impacts on the margin. Indeed, Basel II and its bifurcated application in the U.S. offer a number of possible advantages to the B of A and other AIRB banks with considerable expertise in the mortgage business. Some examples include:
   a. Increasing investments in the credit risk associated with both conforming and nonconforming mortgages (some "reallocation of credit risk capital" to mortgage credit risk);
   b. Less reliance upon mortgage insurance and more self-insurance;
   c. Less likely to securitize residential mortgages to hit a particular Tier one/Total capital target.
4. *Current mortgage portfolio of B of A.* The I competitive impact of Basel II in the mortgage market may depend on the extent to which AIRB and non-AIRB banks are currently holding and retaining the credit risk in mortgages they originate or purchase, and the extent to which they directly compete in particular mortgage product markets. For example, the larger the amount of mortgage investments held by non AIRB banks relative to AIRB banks, the larger is the amount of business that can be captured by the AIRB banks from the nonAIRB banks, all

else equal. We queried the B of A regarding the nature of its current portfolio. Here are some general characteristics of note:

a. B of A's portfolio of residential mortgages contains a surprisingly high proportion of conforming, conventional whole loans. Currently, their holdings of fixed rate mortgages are nearly evenly split between conforming and non-conforming purchased and originated. This is different than is typical for most banks since the GSEs are widely believed to dominate the holding of credit risk in the conventional conforming segment of the market.
b. Much of the conforming loan portfolio is purchased loans; only a small proportion is "warehouse" loans (awaiting sale).
c. The B of A is currently has a reduced appetite for holding mortgage credit risk. The average current loan to value ratio among loans in its portfolio is relatively low and around 60 percent or so. They are also more interested in using credit derivative tools to lay off such risk rather than take it on.
d. The B of A's holdings of whole loans are influenced by accounting rules (FASB 115) and its overall asset-liability management strategy. Holding these in the "held for sale" category allows the mortgages to be recorded at amortized cost and not marked to market each reporting period. During other interest rate environments or with a different asset-liability position in its overall portfolio, this may not be as important.
e. Capital for interest rate and for operating risk is allocated at the macro level—they generally do not affect investments in mortgage credit risk at the margin.
f. B of A's internal models are broadly consistent with the amounts of capital assigned by Basel II, although and as noted below, they would prefer even lower values (lower asset correlation) as a Pillar I statement of minimum capital levels.

5. *Data requests.* A critical determinant of the competitive impact of Basel II is the current distribution of credit risk on mortgages held by banks. If the amount of such risk is relatively low, then nonAIRB banks would suffer little since they hold little today. This may be the case if the GSEs, capital markets via securitization, and some large banks currently dominate this market. We discussed call report data used to shed light on this issue, but all acknowledged the call report data was too aggregated to address this question for a particular bank. Hence, the FRB staff makes these data requests in order to understand better the composition of B of A's mortgage portfolio:
   a. Distribution of their portfolio of 1-4 family mortgages by product type, e.g. prime, conforming vs. nonconforming, Alt-A, ARMs, subprime, etc
   b. Distribution of their holdings of securities by tranche;
   c. The fraction of their 1-4 family mortgages in the 50 percent risk bucket; and,
   d. Information about its relatively new synthetic security to lay off credit risk on mortgages (e.g. RESI 2002-A).

Key Points Discussed Regarding Implementation.

1. *l O percent floor on LGD is binding:* B of A noted their dislike for this particular provision in its comments. The discussions helped quantify the significance of the floor. About two-thirds of its current portfolio of residential mortgages would be directly affected by this floor. This may be on the high side over a longer period of time and reflects in part the current conservative posture of the B of A. Nonetheless, its models find the floor to inappropriate. This view is also highly influenced by its decision to use a "through the cycle" LGD concept whereas Basel II uses a stress or recession LGD. The B of A has offered to assist in the development of this policy.
2. *Introducing maturity distinctions may help reduce the excessive capital differences between home equity and 3O year fixed rate mortgages:* The B of A distinguishes between a maturity effect and the asset correlation whereas the asset correlation parameter in the FRB model and Basel II for mortgages reflects both. This causes some potential problems and differences that are particularly acute for home equity loans. The average maturities for home equity loans are much smaller than 30 year fixed rate mortgages and their internal asset correlation parameters are lower, too. This issued is discussed in more detail on pg. 31-36 of its comments.
3. *Pillar I vs. Pillar II treatment.* We discussed whether some issues are best handled in Pillar I vs. Pillar II. For example, the treatment of potential haircuts for mortgage insurance may best be considered in Pillar II owing to the high ratings of MI companies and the potential complexity of dealing with these haircuts in Pillar I via LGD adjustments. Another example pertains to the 10 percent floor on LGD. Exceptions may be granted in Pillar II for those banks with substantial evidence of the floor being binding. The B of A emphasized its preference for resolving some of these issues in Pillar I since the Pillar I calculations of regulatory capital are publicly disclosed. Adjustments in Pillar II do not. Since the B of A believes that such an approach heightens the transparency of Basel II.
4. *The role of borrower wealth and home equity loan performance.* The B of A emphasizes borrower net worth in its models of home equity loans and other consumer credit, whereas most residential mortgage models and the B of A's model focus upon the current loan to value ratio on the property. This leads to different conclusions regarding the appropriate amount of capital for home equity loans that is generated by Basel II.