# BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DIVISION OF RESEARCH AND STATISTICS

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**Date:** March 4, 2004

**To:** Myron Kwast

**From:** Paul Calem and Jim Follain

**Subject:** Report on Conference Call with Countrywide Financial Corporation (CFC) on October 10,2003

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Participants: Nick Krsnich (Chief Investment Officer); Sherry Whitley (Regulatory Relations and Reporting); Rob Speaks (SF Federal Reserve Bank); Paul Calem and Jim Follain.

We began with our plans for summarizing the meeting and, possibly, referring to parts of the discussion in the paper produced for this project. We also indicated that we will send them a draft of what we considered to be the main themes of the meeting for their review and approval. They did have access to the attached document prior to the meeting. We began with a more general discussion of the issues and ended with a review of each of the questions in the attachment.

**Overview of Issues**

1. *Table I results are plausible.* The results in Table 1 are generally consistent with their internal default models with regard to loss frequency and severity; that is, the new Basel II rules for AIRB banks will align much more closed with their estimates of economic capital for such credit risk than Basel I. They are interested in seeing more analysis of subprime and HELOC loans. We promised to send our paper on the asset correlation to get more specific input from them on this issue.
2. *Would the bifurcated nature of Basel II and its reduced regulatory capital for residential mortgages lead CFC to "opt-in"?* Maybe, but regulatory capital will not be the primary consideration, for several reasons.
    a. First and foremost, CFC primarily engages in the business of mortgage banking: originating and servicing loans and secondarily investing in mortgages or retaining credit risk. The organization includes a deposit-taking bank subsidiary; however, only about 10 percent of the mortgages originated by CFC are held in portfolio (mostly at the bank subsidiary), and the rest are generally sold without recourse. As such, the ability of CFC to compete effectively depends on the totality of issues associated with the mortgage banking business such as sound underwriting, servicing, and customer relationships, with capital one of many important components.
    b. Second, CFC believes the company's sound business model and expertise in the mortgage business makes its competitive position strong, enabling it to weather any capital disadvantage it may face under Basel 11. CFC believes that specialization in mortgage banking provides it with natural advantage, including concentration of expertise and flexibility in making strategic decisions. Similar considerations would apply to any bank considering whether to opt-in to AIRB status.

   c. Third, the cost of opting-in is viewed as substantial in terms of human and technological capital, although little detail was offered regarding the nature of these costs.

3. *The bank subsidiary was created (de novo) in 2001 primarily to invest escrow accounts, obtain less volatile spread income, provide portfolio investment opportunities, and also for the purpose of cross-selling other consumer loan products.* The bank's mortgage portfolio consists primarily of second-liens (primarily HELOC), CRA-type products, and adjustable-rate mortgages.
4. *A decision to evolve from a mortgage banking business into one with more long-term investment in mortgages or mortgage credit risk would increase the likelihood of opting-in.*
   a. An expansion of second-lien lending would be particularly likely to motivate opting-in, due to the particularly large disparity in regulatory capital for second lien mortgages requirements between A-IRB banks and others under Basel 11.
   b. A decision to more fully integrate the banking platform (e.g. deposit collection, investments, and spread income) with the mortgage banking business (originations, servicing, and income generated by gains on sale) would increase the likelihood of opting-in. Such a decision has not been made.
5. *CFC offered an interesting example to make the point that small differences in capital costs due to differing regulatory or accounting regimes tend not to have substantial competitive effects.* The example has to do with the hedging of mortgage servicing rights, which is a costly activity for an institution such as CFC. This is needed to provide balance between production and servicing income and comply with various accounting standards. Larger banks may not hedge to the depth of CFC because of larger portfolio assets and other income generation. But despite this advantage, CFC is able to compete because of their expertise in the mortgage business. An article located on their web site provided much more information about the nature of this argument. For example, they highlighted the capital requirements permitted by the ratings agencies for their servicing business (about 1/3) to the 8 percent allowed for banks.
6. *CFC also offered some general observations regarding the mortgage market that are relevant for evaluation of the competitive effects of Basel II.*
   a. The market is highly liquid for most types of mortgages. The market is able to purchase pools of mortgages in 3 short periods of time, i.e. 30-90 days for both conforming and jumbo pools.
   b. The market is particularly "deep" with respect to 1$^{st}$ lien prime collateral credit risk—it is "easy to sell credit risk". Agency collateral has a well defined credit market provided by the GSEs and non-conforming prime collateral can be placed in private label securities. 2$^{nd}$ lien and sub-prime collateral usually results in the issuer retaining some residual interest.
   c. Hence, to the extent that capital becomes a constraint on the ability of some banks to retain credit risk, this should not greatly affect their origination business.
   d. Would Wall Street provide new products to allow unbundling of interest rate risk and credit risk on residential mortgages if needed? Yes, such a need will be met if demand is sufficiently strong. Indeed, there are precedents in the market. However, CFC stresses that investors in these credit derivatives would likely come from the ranks of those with substantial knowledge of the mortgage business, especially those who invest in the mezzanine and lower rated tranches of mortgage-backed securities.

**We also discussed specific questions posed in the handout distributed prior to the meeting. The notes from this final part of the conversation are listed below.**

*Purpose of Study:* The purpose is to examine the potential of Basel II to generate an advantage to AIRB banks or thrifts in the market for 1-4 family residential mortgages *investments.* Basel II would reduce the minimum regulatory capital charge for the *credit risk* associated with investments in high quality 1-4 family residential mortgages and in the higher rated tranches of nonagency mortgage-backed securities relative to Basel I. The question is whether this reduction would lead to significant increases in the demand for such investments by the AIRB banks and thrifts at the expense of non-AIRB banks and thrifts who would continue to operate under Basel I rules. (Table 1 attached).

*Purpose of Interviews:* **A** number of banks, thrifts, rating agencies, and investment banks are being contacted during the ANPR period to seek both general and specific feedback on the question. Because these interviews are taking place during the ANPR period, broad summaries of the interview may be made part of the public record. However, specific information of a proprietary nature (for example: internal economic capital assignments, proportion of originated loans sold to the secondary market, length of time between origination and sale) will remain proprietary.

*Specific questionsfo r discussion:*

1. Background information:
   - For which mortgage product / risk segments is total economic capital substantially less than regulatory capital under Basel I and II?
     1. CFC generally confirmed the results in Table 1 but added the importance of looking further into the capital for 2nd liens and HELOCs.
   - What is the extent of your investments in Jumbo prime fixed-rate or adjustable-rate loans and MBS?
     1. The bank investments tend to be in 2nd liens, ARMs, and HELOCs. Most of this is adjustable-rate although some fixed rate loans are made for CRA purposes. Fixed Rate Jumbos are generally securitized and sold.
   - What fraction of your 1-4 family mortgage investments would qualify as "conforming"?
     1. 70% of fundings are conforming but most of the bank investments are not conforming 1st lien fixed rate mortgages.
   - What fraction would qualify as subprime?
     1. Our understanding is that most of these loans are securitized and sold with NO recourse. CFC holds residual interests in which loss expectancy modeled. In some instances CFC purchases "deep MI" in which all or a portion of the risk is borne by MI's.
   - To what extent are these investment patterns influenced by regulatory capital requirements?
     1. Discussed above.
2. Business model issues:
   - Do internal pricing policies assign significant weight to regulatory capital requirements?
     1. Discussed above
   - What obstacles or market realities may limit the ability of banks to take advantage of the lower regulatory capital requirements for these investments?
     1. Discussed above, but the key point is that any serious investor must have a business focus or expertise in the overall mortgage business.
   - We are particularly interested in the role of interest rate risk in mortgages.

1. For example, would concerns about the interest rate risk associated with mortgages and the difficulty of unbundling credit and interest rate risk dominate any reductions in the regulatory capital requirements for the credit risk in such investments?
    a. The market for Jumbos/conforming and even ABS home equity loans is highly fluid. Loans can be sold in 30-40 days in normal environments and typically 60-90 during refi booms. Hence, laying off the interest rate risk via securitization is not a problem.
    b. Nonetheless, Basel II might lead to a reduction, probably modest, in the fraction of the bank's investments mortgages (whole loans plus securities) that is securities.
2. Also, the demand for adjustable-rate mortgages by AIRB banks increase owing to their lower regulatory capital charge and their lower interest rate risk?
    a. It's possible that banks may hold larger residential loan portfolios (including ARMs) due to lower capital requirements.

- Does the investment decision hinge upon a strong originations business model or are they largely separable?
    1. For example, would "reps and warrants" lead to excessive and difficult to manage capital requirements?
        a. Reps and warrants relate only to fraud, as such this would be an operating risk issue not a credit risk issue.
    2. Would the length of time from origination to sale be much affected by the reduced capital charges for credit risk?
        a. Possibly, but probably not much.
    3. Does the investment decision hinge upon the liquidity of the mortgage investments; for example, would highly liquid MBS still be strongly preferred over whole loan investments?
        a. It's possible that the extra yields on whole loan investments (given lower capital charges) may increase holdings versus MBS alternatives.

3. The "opt-in" decision
    - Is the reduction in regulatory capital for residential mortgages a key factor in likely to influence your decision to "opt-in" to Basel II?
        1. Discussed above
    - What are the drawbacks to opting-in?
        1. Discussed above
    - How would your business model be affected if you choose to opt-in or if you choose not to?
        1. Discussed above
4. Other considerations
    - Would the reductions in the regulatory capital requirements for mortgages affect your ability to compete with nonbank entities such as the GSEs or the FHLBs?
        1. Overall, they are not sure. This is a complex issue that depends upon a variety of issues. One of these pertains to the future regulatory treatment of the GSEs, which they view as uncertain at this time.
        2. Would you expect other retail investment decisions to be affected?
5. Overall assessment
    - Would lower regulatory capital requirements for mortgages for AIRB banks and thrifts provide a competitive advantage vs. non-AIRB banks?
        1. Maybe, but no firm conclusion.

- Why or why not? Very complicated with many moving parts! See above.

## Table 1: Proposed Basel II Capital for 1-4 Family Residential Mortgages

*Selected examples of simulated PD, LGD, and Basel II capital by risk segments*

| LTV / FICO Score | Annualized 10-year Default Rate (PD) (percent) (1) | Loss Generated by Default (Recession LGD) (percent) (2) | Risk Weight (percent) (3) | Marginal Tier 1 Capital Requirement (Basis points) (4) |
|---|---|---|---|---|
| 70 / 620 | 0.27 | 16 | 9 | 34 |
| 70 1660 | 0.16 | 16 | 6 | 23 |
| 70 / 700 | 0.10 | 16 | 4 | 16 |
| 70 1740 | 0.07 | 16 | 3 | 12 |
| 80 / 620 | 0.51 | 20 | 17 | 67 |
| 80 / 660 | 0.31 | 20 | 12 | 48 |
| S0 1700 | 0.20 | 20 | 9 | 35 |
| 80 1740 | 0.15 | 21 | 7 | 29 |
| 90 / 620 | 1.00 | 25 | 34 | 136 |
| 90 / 660 | 0.62 | 26 | 25 | 100 |
| 90 / 700 | 0.42 | 26 | 19 | 76 |
| 90 / 740 | 0.30 | 26 | 15 | 61 |
| 95 .1620 | 1.38 | 26 | 45 | 181 |
| 95 1660 | 0.87 | 27 | 34 | 135 |
| 95 / 700 | 0.58 | 28 | 26 | 104 |
| 95 / 740 | 0.43 | 28 | 21 | 84 |
| Jumbo Prime Pool | 0.27 | 25 | 13 | 53 |
| Alt-A Pool | 0.28 | 35 | 19 | 77 |
| Seasoned & Diversified Portfolio of Prime Loans | 0.19 | 25 | 10 | 40 |

Source: Calculation by FRB staff.