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: Meeting with Fitch Ratings on Competition Project

Attendees from Fitch Ratings: Steve Grundleger (Managing Director) Michael Nelson (Senior Director), Sarbashis Ghosh (Senior Director), and Kim Olson (Senior Director). Steve, Mike, and Sarbashis are in Structured Finance, Residential Mortgages. Kim is in the Credit Policy Group and serves as the firm's regulatory liaison.

Fitch opened with their brief overview of the documents Fitch has written about Basel II and they encouraged us to read their public documents. These can be obtained at: http://www.fitchratings.com/corporate/reports/ They are entitled "Basel 11: Refinements to the Framework," February 6,2003; and "Basel II Securitization Proposals: Primer and Observations," April 22, 2003.

The remainder of this memo highlights other major themes emphasized during the meeting.

1. *While the Basel 11 measures will provide a more risk-sensitive yardstick for comparing capital adequacy across institutions, using the ratios to make precise comparisons will still be a challenge.* This is due in large part to the number of underlying assumptions built into the framework and the potential lack of transparency as to how supervisors plan to think about the size of the additional buffer that banks will need to hold above the Pillar 1 minimum. Supervisors are empowered under Pillar 2 to address cases where the Basel assumptions might not fit the risk profile of a particular institution (e.g., concentration exposures that exceed the Basel parameters). However, it is unclear whether national supervisors will apply these "overrides" in a uniform manner across countries, potentially resulting in capital ratios that do not appropriately reflect the true underlying risk profile of some banks. Fitch will continue to weigh the Basel ratios as one of several inputs in the multi-faceted, individualized analysis that goes into their ratings of financial institution.
2. *In view of the above, it is important that supervisors provide transparent guidance for how they will assess bank capital ratios in light of Basel II.* While it is typically not (nor should it be) the role of supervisors to discuss publicly a

bank's internal approach to capital planning, it would be helpful for them to provide clear and open guidance about their supervisory methodologies and expectations for evaluating risk-based capital under a Basel II regime. Greater supervisory transparency will help to promote: (1) consistency in how supervisors evaluate capital adequacy and require adjustments to the Basel ratios across institutions; and (2) a better understanding among supervisory staff in how to examine and monitor Basel II banks. In addition, supervisors should push for more disclosure in how banks evaluate the amount of "buffer" capital banks need to hold above the Basel minimum to take into account, for example, the results of internal stress-tests. In this regard, a clearer understanding in the marketplace of each bank's thought process would help investors to evaluate whether, in their view, banks are holding sufficient capital relative to their risk profile, thereby improving the market's ability to discipline bank behavior.

3. *The marginal cost (MC) of entry to AIRB status is likely to decline over time.* Improvements in data bases, diffusion of knowledge, and consulting firm expertise will make it easier and less for nonAIRB banks to become AIRB banks. This will help mitigate any initial competitive inequities as more banks are able to opt-in.
4. *Pillar 11 add-ons should be more transparent and better linked to market perceptions.* This seems particularly relevant to the issue of capital add-ons for regionally concentrated mortgage portfolios. It is also relevant to any stress tests that are used in supervisory reviews. More generally, the add-ons for any particular risk ought to be visible and consistent with market requirements for similar risks. Fitch, for example, would encourage more use of the ratings of the major rating agencies.
5. *The buffer between actual and regulatory capital is a function of several factors.* One particularly emphasized is the franchise value of the bank. All else equal, bank capital will exceed regulatory capital because regulatory capital is focused upon existing assets and liabilities whereas the bank will also hold capital for future business opportunities or franchise value. Fitch uses a variety of criteria in addition to the Basel ratios to evaluate capital adequacy for a bank.
6. *CCC is equivalent to a "median" loss but less than the average loss over all scenarios.* This is relevant to the calculation of unexpected losses as the difference between losses in a particular tail event less expected losses. Something closer to B or B- is more appropriate. A few other numbers were offered: AAA = 6 standard deviations; BBB = 2.5 s.d.; and BB = 1 s.d.
7. *AIRB banks gain an advantage in the investment in ARMs and low risk JUMBOs.* The distribution of originations among banks will be little affected, but the non AIRB banks may securitize more of their high quality originations than they currently do, particularly ARMs. Non AIRB banks may also end up holding a higher fraction of the riskier mortgages as standardized banks benefit from more lenient capital treatment for lower-quality securitized assets. Fitch thinks that the bifurcated system may shift investment incentives.
8. *The bifurcation of the securitization rules for investors versus originators is another potential contributor to changes in investment decisions that may lead to further concentrations of riskier mortgages in the portfolios of nonAIRB banks.* This is a point particularly emphasized by Fitch. They pointed to examples in their

publications to highlight important differences between the supervisory formula applied to originators and the ratings based approach available to investors under Basel II. The supervisory formula seeks equivalence between the total amount of capital an originating bank must hold for a particular portfolio of mortgages (and other exposures) and the sum of the capital charges of each of the tranches associated with a security built upon these loans. This would make the originator/seller indifferent between holding and securitizing, from a regulatory capital perspective. However, buyers or investors in the tranches have the option of using a ratings based approach for its regulatory capital requirements rather than applying the supervisory formula. At the same time, non AIRB banks remain subject to the old regime. Fitch is concerned that this patchwork of requirements applicable to securitizations may lead to nonAIRB bank originators having a comparative advantage in the riskier tranches relative to the AIRB banks. Overall, there is the potential to increase the risk profile of the less-sophisticated institutions due to a relative lack of granularity in the recourse rules vis-a-vis the AIRB securitization rules.

9. *Fitch offered to assist in the development of more examples to highlight the potential for distortion in the competitive landscape for securitization.* The goal would be to utilize their experience and data bases to quantify the likely impact of this effect.