BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
DIVISION OF RESEARCH AND STATISTICS

Date: March 4, 2004

To: Myron Kwast

From: Paul Calem and Jim Follain

Subject: Meeting with S& P on Competition Project

Here are the main points that emerged from our meeting with Frank Raiter of S&P andhis staff on December 11, 2004.

1. *RMBS collateral may be on the safe side.* S&P provided handouts regarding the characteristics of loans that are securitized. We also discussed the characteristics of loans that are held by banks and not sold or securitized. Although their data do not directly address this issue, their sense is that:
    a. Low risk mortgages tend to be sold or securitized by banks;
    b. Hybrid ARMs tend to be held, although the streamlined refinance process makes FRMs look more like surrogate ARMs.
    c. Refinances with little or no cash out tend to be held whereas loans for purchase tend to be sold.
2. *ARMs may be a fertile battleground.* Many banks have done well by investing in ARMs. They are especially valuable to the smaller bank that is largely dependent on deposits. The combination provides a nice opportunity to manage the interest rate risk associated with mortgages and still earn a high yield. Basel II may provide enough of a capital advantage for the AIRB banks to make them increase their efforts to market ARMs to consumers during more normal economic times (upward sloping yield curve with higher level of rates on fixed rate mortgages). If so, they would be able to shift some of the market for such products from the balance sheets of the nonAIRB banks to the AIRB banks.
3. *Basel II's impact in this regard will be cyclical.* We infer from these two sets of points that the impact of Basel II and its bifurcated system on the competitive landscape for mortgages is likely to be *cyclical.* It may be largest when the demand for ARMs (vs FRMs) is largest; that is, when nominal rates are high and the spreads between fixed and adjustable-rate mortgages are high. During such a time, AIRB banks may find themselves able to garner a larger share of the market for ARMs than they have in the past. In addition, AIRB banks may be in a better position to bid business away from nonAIRB banks during the next refi boom since rate in term loans made during such times have been, in the past, less likely to be securitized.