FROM THE EU, A FEW THOUGHTS ON BASEL II

The cement continues to harden around Basel II. Specifically – and in too much detail -- the Bank for International Settlements' Basel Committee on Banking Supervision has issued a third consultative paper on the New Basel Capital Accord. This third and near-final round contained little new regarding the capital required to support mortgage lending activities. The relatively few lenders expected to achieve the internal ratings-based (IRB) approach will still be given the latitude to establish their own risk weightings, subject to a floor of 10%.

The major piece of news was a proposed 35% risk weighting for mortgages under the "standard approach," down from the earlier 40%. Important for the standard approach lenders was a caveat from the Committee. It was offered that this "concessionary" 35% risk weighting be

> …*applied restrictively for residential purposes and in accordance with prudential criteria, such as the existence of substantial margin of additional security over the amount of the loan based on strict valuation rules. Supervisors should increase the standard risk weight where they judge the criteria are not met.*

With a preconception to closely follow the precepts in the Accord, the European Union will debate how the ultimate Basel Accord applies in the EU. That being said, it's predicted that the EU Directives may not carry the explicit language above. Regardless, it is clear that the Basel Committee recognizes the inherent differences in residential mortgage loan quality and resulting performance.

I have offered in previous articles in this publication that loan-to-value (LTV) is an unambiguous, pervasive indicator of default probability and loss. IRB lenders will without question use LTV as a part of their capital settings. So it would be surprising for national regulators who must ultimately interpret, implement, and monitor the new capital rules to overlook the predictive power of this single indicator. Who knows how it will come out, but a risk weighting of 50-100% on loans above 75-90% LTV can reasonably be anticipated.

A capital surcharge for high-risk loans is not an insignificant concept. It is widely expected that the IRB lenders will on average apply a 35% capital risk weight for mortgages. Nevertheless, the IRB lenders will have a self-imposed disincentive to generate too many higher-risk loans. Their models will demand incrementally more capital on these mortgages, dragging their average risk weight upwards. Standard method banks, alternatively, have no disincentive to generate high-risk mortgages – their capital risk weight is fixed. Regulators are likely loathe to establish a system that pushes the smaller, sometimes less sophisticated lenders into higher risk lending in order to compete against their larger, better leveraged brethren.

Related to the discussion above are the "Credit Risk Mitigation" (CRM) techniques described in the proposed Accord. To reduce capital charges against assets, the Committee contemplates several risk hedges: collateralization by cash, third-party guarantees, or the acquisition of a credit derivative. In regards to a residential mortgage portfolio, the last two are relevant. For a standard approach lender, the third is less applicable because the economics of these instruments require large transaction sizes to amortize all the associated costs. I would like to address guarantees.

Legally not much of a distinction exists between guarantees and insurance. Practically, there's a larger distinction and the Committee seems to have picked up on this. In describing acceptable guarantees the Committee used words like: "direct," "certain," "irrevocable," "unconditional," and "incontrovertible." Obviously this Basel Accord, before releasing any capital in the system, desires to eliminate any perceived ambiguities in protection agreements. Like everything, this will have a cost.

For background, the table below provides a selected overview of some of the key requirements for a guarantee contract.

ITEM	COMMENT
Irrevocable	No unilateral cancellation except for non-payment by bank
"Fixed cost"	To the extent deteriorating credit performance cannot cause an increase in price
Unconditional	No clause outside the bank's control that would keep the protection seller from paying it obligation
Pay everything	Guarantor to pay all types of payments the obligor was to have paid

Much needs clarification still. For example, how is moral hazard to be addressed? If default losses derive from mortgage fraud, must the guarantor pay? If so, what kind of oversight must a guarantor have to assure itself that these claims are minimized? Is the Basel Committee looking for operational risk cover in the guise of credit risk protection?

This last point is crucial. For a guarantor to offer the kind of protection contemplated in the rules above, it will necessarily have to be intrusive – certainly in its initial due diligence, but in ongoing compliance as well. Granted, a significant goal of Basel II is to encourage all banks to improve their risk measurement and management capabilities. The incentives to pursue this goal rest in the capital advantages of the IRB approach. The hope is that many banks will be enticed to invest in data, analysis, systems, quality control, training, etc. to procure the vaunted IRB status. The trouble I foresee is that some lenders will have to invest far beyond expectations just to acquire credit protection that qualifies for capital relief. Guarantors may be unwilling to extend coverage, with all the requirements now contemplated in the Accord, to banks that cannot demonstrate a high degree of process sophistication and process integrity. Operational risk is entire section of the Accord unto itself. It may have crossed over into the credit risk area.

These hurdles are high, but can be cleared. Of course, there will be a cost to a protection contract that is total. Whether the smaller, non-IRB banks will be able to meet the operational standards or pay the premium cost is something we'll have to see. Let's hope there's still room for the smaller, local and regional lenders that do much to make the mortgage market the important part of European society it is.

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