



REAL ESTATE TECHNOLOGY NEWS

August 2006 • www.retechnologynews.com

Cover Report

Basel II/IA: Opportunity amid the challenge

One of the most significant regulatory changes in the lending industry is looming on the horizon, but are mortgage companies prepared for the shift?

Sometime in 2008, the Basel II accord is scheduled to go into effect for the largest banks in the United States. Other countries could implement the standards as soon as Jan. 1, 2007.

Basel II sets international standards for how much capital banks must set aside to protect themselves from unexpected losses. It introduces stricter guidelines requiring capital reserves to be based on risk criteria.

The accord includes recommendations from the Basel Committee on Banking Supervision, which includes representatives from central banks and regulatory authorities of the G10 countries. The committee does not enforce the policies, but most countries elect to adopt the recommendations as a framework for their own laws. The FDIC, Office of the Comptroller of the Currency (OCC) and Office of Thrift Supervision (OTS) require their lenders to follow Basel, for example.

The accord will be crucial for mortgage businesses around the world because it will affect how much they can lend and will require that they implement more risk-sensitive lending strategies.

“Basel I has been generally perceived as significantly outdated and unnecessarily arbitrary in nature,” said **Darius Bozorgi**, CEO and president of Veros. “Many lenders are scurrying to get into position to comply with new Basel requirements or position themselves to take advantage of its opportunities.”

“Most people have little idea what’s going on relative to Basel, and it’s right around the corner. It’s going to have a major impact and provide greater market efficiencies, which is good for the mortgage industry as new Basel requirements are geared around a risk-based approach to mortgage lending and to capital,” Bozorgi said.

Meeting the requirements

Basel I is essentially a non-risk-responsive capital accord. Assets fit into certain “buckets” and are assigned a corresponding capital amount. Those buckets might be broken down by FICO and LTV — for example, all loans under 90 percent LTV would be grouped together with similar capital reserve requirements.

“It’s not distinguishing between a negative-amortization option-ARM with a 450 FICO on a 110-percent LTV or something squeaky clean,” said **Mark Fleming**, chief economist with CoreLogic.

Basel II is based on complex risk models and will likely affect the top 10 or 20 banks — some of those will be required to adhere to it, and some will opt to.

“The key differentiator with Basel II is it will allow you to risk-base-price individual loans and calculate that capital requirement with more of a risk-sensitive approach,”





Fleming said.

The roster of organizations that commented in 2005 on Basel II capital requirements for the Federal Reserve Board may provide some indication of who will be affected: Fifth Third Bank, MBNA America Bank, Wachovia, Capital One, Washington Mutual, HSBC, JP Mortgage Chase, Bank of America, Wells Fargo and Citigroup, for example.

Most other lenders will turn to the alternative, Basel IA, for guidance. Basel IA isn't yet finalized, but it's expected that capital calculations won't include as much risk detail as Basel II. According to the OCC, Basel II's advanced approaches should be mandatory only for large, complex institutions. Basel IA aims to give smaller, less complex domestic banks an alternative to current capital rules that increases sensitivity to risk.

"There may be some small (lenders) that will stick with Basel I," said **Dr. Jim Follain**, "but if you're a serious mortgage player, you're going to want to do Basel IA. Wells Fargo, (Bank of America), Citi — all those guys are going to do Basel II."

Follain recently joined the IFE GROUP, an analytics, consulting and technology provider. Most recently with Fidelity Hansen Quality, he has also served as senior economist at the Federal Reserve Board, where he analyzed mortgage provisions of Basel II.

Basel and AVMs

Basel II will require the use of loan-to-value ratios and other formulas to assign risk-weights for mortgages and determine capital requirements.

"Part of that formula deals with the valuation requirement and would look at something like LTV in relation to credit risk," Bozorgi said.

The second part of Basel II requires that the risk weight calculation occurs routinely. Regulators probably won't define how often lenders will have to reassess risk — the rate might be flexible based on the type of business a lender is doing. Reassessments might even occur daily to support transactions for some organizations.

Fleming said, "This is a big advantage of Basel II — adjusting and correcting for values. How often you do it and how often you reallocate your capital isn't specifically prescribed, but there's certainly an advantage to doing it at some periodic frequency."

Sheer loan volume and the need for constant revaluations of loans and portfolios would require an automated approach.

"AVMs will be one of the major tools used to calculate the valuation-related variables of the formulas on a regular and ongoing basis," Bozorgi said.

Companies such as Veros offer AVMs and related collateral-risk scoring tools that will let lenders take full advantage of and optimize Basel capital requirements to become more competitive, he added.

Basel II will therefore mean more business and a new kind of business proposition for AVM providers — namely, large batches of loans, according to Fleming. CoreLogic, for example, offers portfolio "mark-to-market" solutions that use indices to take an origination value, factor in where a property is located and when it sold and update the value.

"That's a very cost-effective way for mortgage originators to process large portfolios to come up with updated valuations and implied updated mark-to-market LTVs," Fleming said.

The use of AVMs for portfolio analysis and Basel II/IA compliance represents a good entry point for automated valuation, Fleming said, and could lead to greater confidence in the tools in other areas of lending.

"The more comfortable you become with the tools, the more you're going to look for other ways to use them," he said.



Follain said portfolio risk assessment represents a homerun for AVMs due to volume discounts. Lenders will have to decide how frequently they want to run AVMs and where they want to target their AVM resources. Basic, “vanilla” AVM-based valuations might occur on all loans quarterly, he said, but lenders might also turn to the same sort of bump logic used in the origination world for riskier loans that warrant a closer examination.

“If you come up with a low confidence score, you may move to a more sophisticated, expensive valuation product,” he added.

The competitive effects of Basel II/IA

Although most agree that sophisticated risk measurement is healthy in concept, only the largest banks will be able to afford to take full advantage of enterprise risk systems and risk-based pricing, Fleming said. They have the vast amounts of data needed to create risk-based pricing models. Smaller institutions will adopt lesser versions, he added. The dichotomy has led to some concerns about anti-competitiveness.

Detailed risk-based pricing could enable large lenders to set aside less capital to cover potential losses; they could therefore dedicate more funds to their regular line of business and charge less for loans. Follain predicted that it will be harder for mortgage specialists — e.g., savings and loans or banks with perhaps one-third to half their assets in mortgages — to keep loans in portfolio due to that advantage.

“When you get out there competing for consumers, the small, specialized lender will have to compete in some other way. If they’re offering the same service as Bank of America, they’ll have a higher cost to fund, in my opinion,” Follain said.

On the other hand, large, complex models will be more expensive than more lightweight options and will require models for examining probability of default based on credit risk, expected loss models, exposure default models and more.

“Some of the biggest lenders already do that,” Fleming said. “The issue for them is proving that they’re doing it in a sound fashion with their regulator.”

He added that the smaller a lender is and the less risk modeling it does, the fewer options it will have within Basel II.

“A small mortgage brokerage or mortgage originator working with a couple thousand loans per month is unlikely to find it cost-effective to build their own risk models,” Fleming said. “They would have to use one of the lesser options within the Basel II framework.”

Some of the competitive advantages bigger lenders could see are linked to market conditions. In certain scenarios, sophisticated risk models could put lenders at a disadvantage compared to competitor without them. For example, in the

Where the GSEs fit in

The Basel accords relate more to credit risk than interest rate risk. **Dr. Jim Follain**, a Basel II expert with the IFE GROUP, noted that with the Basel revisions, the rules for banks are aligning more closely with Fannie and Freddie in terms of credit risk.

“I think there will be more competition,” he said.

However, conventional, conforming loans with low LTVs or mortgage insurance are safe assets with modest credit risk. The greater risk with those loans is interest rate risk. Follain therefore doesn’t expect Basel II to have much impact on Fannie and Freddie.

How much capital you’d have to set aside to keep a loan in portfolio is one of the key components in deciding whether to hold onto it or sell it into the secondary market. Current regulations create a capital advantage for Freddie and Fannie, according to CoreLogic Chief Economist **Mark Fleming**, and basic economics mean it’s less expensive to sell it than to keep it — the capital advantage lets the GSEs offer attractive pricing.

“The efficient allocation of resources would say put that loan with Freddie Mac and Fannie Mae because of the lower capital requirement they have,” Fleming said. “Their pricing shows that advantage, which is why you move it there.”

However, under Basel II, academic studies have shown that certain lower-credit-risk loans might be less expensive to keep in portfolio than to securitize under the GSEs’ current regulatory requirements, Fleming added.

When Basel II goes into effect, lenders could gain the capital advantage. As a caveat, Fleming noted that the GSEs’ regulator could require Fannie and Freddie to adopt Basel II or another regulation that lets them re-establish their advantage.



current environment, models would respond to rising interest rates and force lenders to set aside more capital.

“People often think, ‘Hey, this is great. We’ll be able to reduce our capital as the markets rise.’ Yes, but you’re also allowing for the possibility of when they don’t, you have to go the other way, which is, from a risk perspective, exactly how we’d want it to happen,” Fleming said.

Follain explained that although Basel IA could level the playing field in theory, in the regulatory world, capital has to satisfy both risk and leverage requirements (minimum capital requirements) — the latter is a flat percentage of a lender’s assets. For example, no matter how safe an organization’s assets are, regulators might not let capital drop below 8 percent. Therefore, many mortgage lenders won’t be able to take advantage of Basel IA, Follain said.

How will you prepare?

The current plan is for the U.S. agencies to start running “parallel” in 2008 — lenders will have to start calculating what their Basel II requirements will be, but they’ll still use Basel I requirements for capital. At that time, they will have to be able to calculate capital for both accords, Fleming said.

Big lenders should be looking at existing risk models to determine if they should make adjustments for Basel II, Fleming added. They’ll have to create functionality in their back-end systems or workflow to generate the capital requirement number.

They might also consider companies providing risk-based pricing models that predict and calculate probabilities of default at the loan level. But even that option will require a great deal of due diligence work to make sure the technology satisfies regulators and handles Basel II correctly.

According to Follain, the lesson for banks preparing for Basel II or IA is that the accord isn’t just an IT problem. Small and mid-tier lenders have to understand that the system they implement will in part be based on their own operations and needs, but they can also draw lessons from the high-end modeling Basel II-affected banks will use.

They might build AVM-like cascades that build on existing models but reflect their own niche. Those systems will have to remain flexible to accommodate new loan products that appear.

“My guess is these mid-tier lenders will stay at the forefront of getting into riskier, more novel (loan) products. The IT people need to understand you can’t just build one model and it’s over. This is a dynamic world, and it’s wise to have a flexible system,” Follain said.

Predictive risk models are becoming faster and cheaper to establish and use, he added, and lenders might turn to cascades that combine four or five models that deliver a range of opinions.

According to Bozorgi, existing and future systems and tools — whether developed internally, outsourced or acquired — will let lenders not only identify where they are today more accurately and consistently (providing the data to potentially free up more capital, for example) but also predict and forecast where they will be in the near future. When the new Basel accords are implemented, he added, they will establish a new field of play with new rules, pitfalls and opportunities.

In our next issue, look for more information on the technology that will power Basel II/IA compliance. ■