



Federal Financial Analytics, Inc.

**NEW BASEL II SECURITIZATION RULES MEAN
BIG GSE/INDUSTRY RESHUFFLE, FEDFIN REPORT CONCLUDES**

“Basel II’s complexity often hides its big bang impact on financial markets, but one of the most important of these will be a major realignment between housing GSEs and big U.S. mortgage originators.”

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CONTACT: Josh Kotin (202) 296-5240

WASHINGTON, D. C. – A report released today by Federal Financial Analytics concludes that the new international risk-based capital standards will dramatically alter the competitive balance between U.S. government-sponsored enterprises and the rest of the mortgage finance industry. “Basel Bubbles Mean Toil and Trouble” was released today by Federal Financial Analytics (FedFin) to clients to assess the degree to which strategic planning needs to change now to anticipate risk-based capital (RBC) requirements. Although the United States has postponed Basel II implementation, the EU, Japan and other nations will put the simpler version of the new rules into effect next year. FedFin finds that this schedule ensures immediate market impact, even as the more complex Basel II models are finalized.

Releasing the report, FedFin managing partner Karen Shaw Petrou noted that, “One of the reasons Fannie Mae and Freddie Mac have grown so big so fast is their regulatory capital advantage. When Basel II comes into effect, this advantage is up for grabs, and there will also be new disincentives for banks to send low-risk mortgages into the secondary market. Fannie and Freddie will thus need to rethink their business model. Given their giant size, any change of course will set up a huge wake for everyone else.”

Key findings in the FedFin Basel II report include:

- Because Basel II’s standardized credit risk option will be in place in major markets (but not the U.S.) on January 1, 2007, its impact on the GSEs and global mortgage finance is immediate.
- Conventional, conforming mortgages – especially ARMs – will increasingly stay on bank books, not go to the GSEs. Banks could also out-bid the GSEs for conventional conforming product from non-banks, as well as take back some share on home-equity loans. Banks will still have to comply with the leverage requirement for these assets. This is higher than the comparable GSE number. However, there are lots of ways to fix this problem that do not adversely affect the basic new ability of banks to fight head-on with the GSEs at the point of loan origination.
- If the GSEs don’t go higher risk, then Basel II’s impact will put them in a very tight squeeze. Other than seeking statutory change or privatization, Fannie and Freddie will need to respond by using their brand names to reach farther down the origination food chain, obtaining product directly from brokers or even real estate agents.
- The push on prime business will also force the GSEs – again assuming no larger change – into more fee-based businesses and product structures that rely on credit enhancement or other features to keep their pipeline full.
- A range of new mortgage securitization instruments will enter the market, with the GSEs taking not only some credit risk, but also a range of others – principally interest-rate risk – that would otherwise limit investor MBS or whole-loan holdings. The crimp in the FHLB mortgage purchase programs will limit their competitiveness as this market opens up.

- Basel II will broadly eliminate the benefits GSEs now enjoy on the RBC treatment of MBS, debt and equity. This could have a particularly dramatic effect on the Home Loan Banks, with some big banks taking another look at why they belong and what they want in return for these higher-cost equity positions.

Copies of the FedFin report are available on request. To obtain one, call Arezou Rafikian at 202-296-5240 or e-mail INFO@FEDFIN.COM

Federal Financial Analytics, Inc. has for the past eighteen years counseled large financial institutions and even their regulators on major legislative, regulatory and policy issues that pose strategic risk. It does not lobby on behalf of clients, but advises them on appropriate responses in light of identified challenges, working on an array of Basel II policy and implementation issues. The firm publishes an array of information and analytical services, including GSE Activity Report.

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