Basel II/CRD & Mortgage Credit

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Agenda

- **Introduction Basel II & CRD**
- **Pillar I: Treatment Of Mortgage Credit**
- **Operational Risk**
- **Credit Risk Mitigation & MI**
  - RSA
  - A-IRB
- **Pillar II and III**
- **Basel II and Mortgage Funding**
- **Conclusions**

Introducing Basel II & The CRD

Review of the 1988 Accord With Two Parallel Processes….

Basel Committee on Banking Supervision

- Voluntary
- For Internationally Active Banks
- More Restrictive

EU: Revision Of The CRD

- Compulsory For All EU Members
- For All Banks And Investment Firms
- More Flexible
- EU Specific

Overall Goals

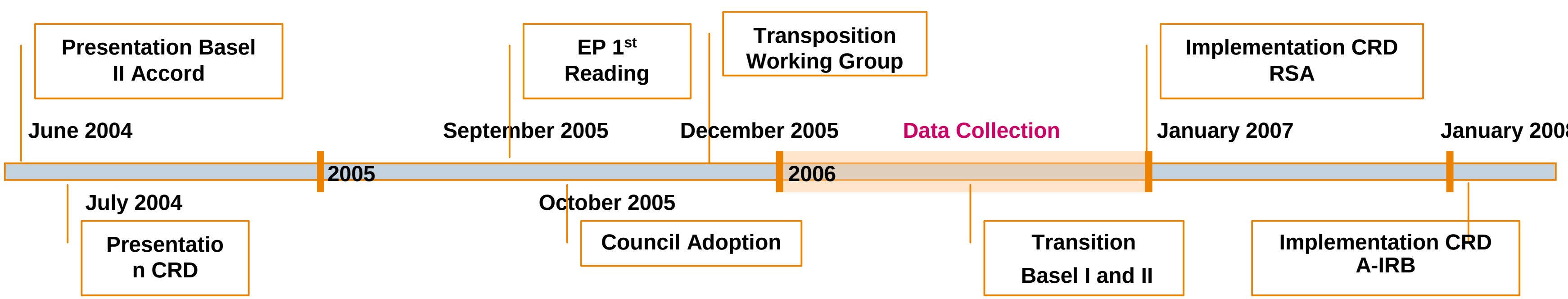
Better Risk Measurement

- Comprehensive Coverage
- Enhanced Risk Sensitivity
- Greater Emphasis on Bank's Own Risk Assessment

More Flexibility Regarding Credit Risk

New Emphasis on Market Discipline Through Disclosure

Timeframe



Basel II Significantly Broader Than Basel I

		Basel I	Basel II	
Pillar I	**Minimum Capital**			
	Credit Risk	✓	✓	Basel I Uses "One Size Fits All" Approach To Setting Minimum Capital Basel II Introduces Three Different Approaches [RSA, FIRBA, AIRBA} Basel II Offers Capital Incentives Under More Advanced Approaches
	Market Risks	✓	✓	No Changes Proposed For Market Risk Between Basel I and II
	Operational Risks	N/A	✓	Basel II Introduces Explicit Capital Charge For Operational Risk Basel II Introduces Three Different Approaches Insurance Recognized CRM Under the AMA Approach Only [20% Cap]
Pillar II	Supervisory Review	N/A	✓	Organizations Should Have A Process For Assessing Overall Capital Supervisors Should Review And Evaluate Banks' Internal Capital Adequacy Assessment And Strategies, Supervisors Should Expect Banks To Operate Above The Minimum Regulatory Capital Ratios Supervisors Should Seek To Intervene At An Early Stage To Prevent Capital From Falling Below The Minimum Levels
Pillar III	Disclosure	N/A	✓	Market Discipline Encourage Via Risk Transparency

Basel II Intended To Encourage Greater Risk Sensitivity

Pillar I: Treatment Residential Mortgages RSA/IRB

Basel I

Global Standard Of 50% RW…

UK	50% <100%LTV
Netherlands	50% <75% 100% >75% (portion)
Germany	50% < 60% 100% >60% (portion)
Spain	50% <80% 110% > 80%(all)
France	50% All
Italy	50% < 80% Guarantee For >80%
Denmark	50% <80% 100% > 80%
Sweden	50% <100%
Portugal	50% < 75% 100% > 75% (portion)
Belgium	50% All
Ireland	50% All
Greece	50% All
Austria & Lux.	50% < 60% 100% > 60% (portion)

Basel II - RSA

Global Standard Reduced To 35% Risk Weighting (2.8 Cap. Charge)

Standard Subject To Prudential Restrictions, And Reference To Prudent Loan-To-Value Ratio

High LTV Threshold Not Specified, But EU Commission Has Proposed Prudent LTV Limit Of 80% For Mortgage Bonds

High LTV Risk Weight Not Specified, But General 75% Risk Weight For Retail Assets Most Likely Choice

Implementation Depends On National Supervisory Discretion, But New Tough Language:

- Must Develop Clear Criteria

Past Due Exposures Risk Weighted At 100%

Basel II – A-IRB

Standard Risk Curve, But No Standard Risk Weight

New Floor: < LGD = 10% Transitional

Lender Supplies Key Inputs

- Probability Of Default - PD
- Loss Given Default - LGD
- Exposure At Default - EAD

Inputs Derived From Portfolio Segmentation And Internal/External Data

Supervisor Must Approve Segmentation Method And Data Used

Basel II Identifies LTV As "A Key Risk Driver", And States…

- Preference For Segmentation Method That Combines LTV And
- Borrower Credit Info

Expected RW Under A-IRB ~13%

Few Absolutes…Regulatory Discretion Is Key But Full Benefits Not Before 2010

Pillar I: Operational Risks

A New Category Of Risks, Hard To Define and Hard To Measure

"The Risk Of Loss Resulting From Inadequate Or Failed Internal Processes, People And Systems Or From External Events"

✓ **Defined As Everything That Is Not Credit Or Market Risk**

✓ **Two Principal Types Of Loss**

- High Frequency/Low Severity Events (Processing Errors, Instrument Fraud)
- Low Frequency/High Severity Events (9/11, rogue trader)

✓ **Three Approaches… Like Credit Risk**

- Basic Indicator (BIA)…Standard Charge X Gross Income/Assets
- Standardized (SA)… Business Line (BL) Specific Charge X BL Gross Income
- Advanced Measurement (AMA)… Like IRB, Using Internal Data On Loss

✓ **Charge Expected To Be 12% Of Current Minimum Regulatory for BIA and SA**

✓ **Limited Recognition of Insurance Under AMA = only 20% of Total Capital charge For Operational Risks + Eligibility Criteria**

Credit Risk Mitigation - RSA

General Principles

The Guaranteed Exposure Should Not Attract A Risk Weighting Lower Than That Of Direct Exposure To The Guarantor.

Counterparty Credit Rating: At Least A-

Guarantees Shall Be

- Direct
- Explicit
- Irrevocable
- Unconditional.

Claims Shall Be Paid Within Max 24 Months From Default

Proportional Recognition Of Credit Risk Transfer Benefits

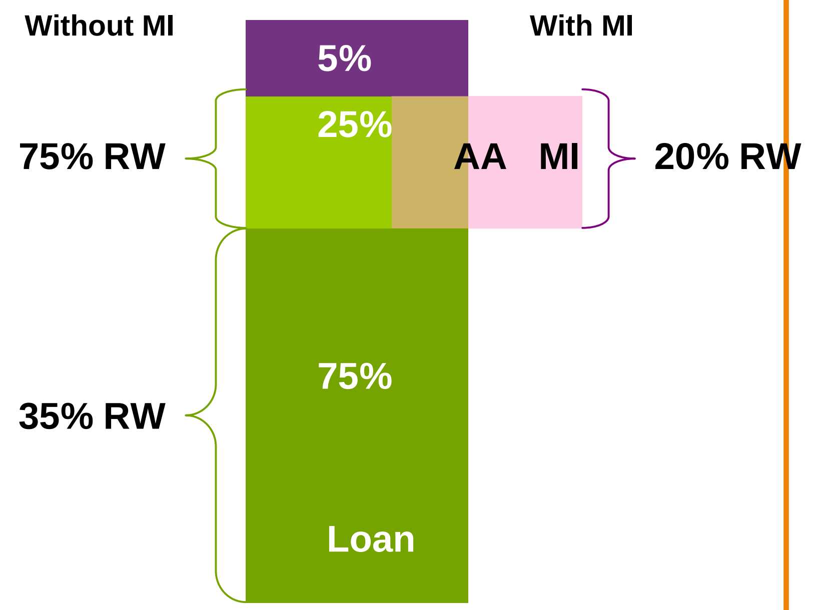
Substitution Approach Used = Counterparty Risk Weight Is Applied To The Portion Of The Mortgage Loan Covered By MI

MI Not Explicitly Recognized CRM But Falls Within The Broad Definition Of Unfunded Credit Protection

Risk Weighting [RSA]

Application Of the Substitution Principle

Loan: €100K LTV: 95%



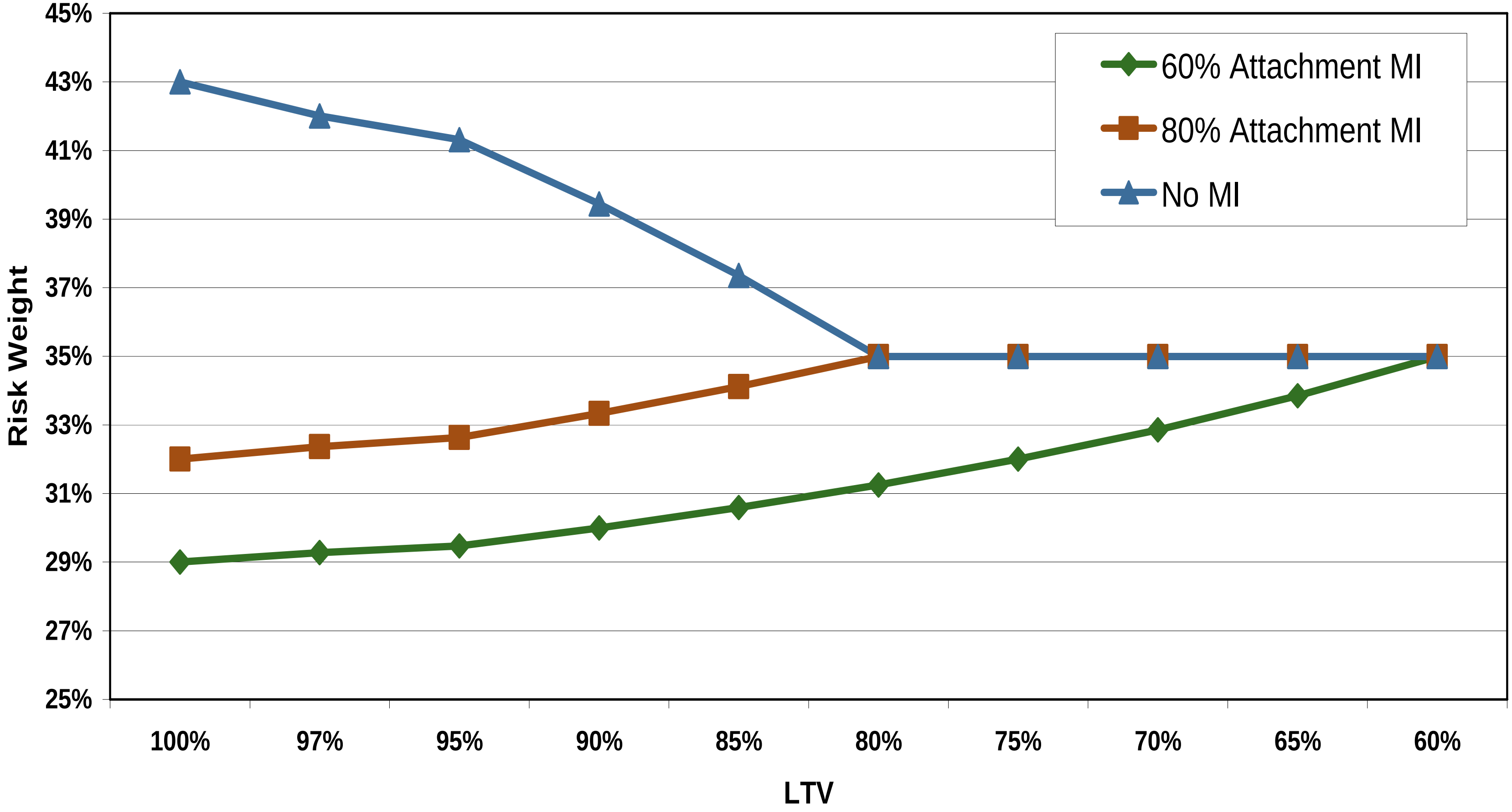
Capital Requirements

W/O MI: [2.8 % * 75]+[6% *25] = [€2.100 + €1.500]= €3.600

With MI: [2.8% * 75] + [1.6%*25] = [€2.100+€400] = €2.500

Rated MI Eligible As CRM Under Basel II … Deeper Cover Encouraged

Calculating The Benefits of MI - RSA



Credit Risk Mitigation A-IRB

A Valid Guarantee

- Evidenced In Writing
- Non -Cancellable
- In Force
- Legallly Enforceable
- Conditional Guarantee Eligible

Counterparty Credit Rating

- No A- Minimum
- Counterparty Position Management
  - Ability/Willingness To Pay
  - Concentration Limits
- Counterparty Details Must Be Disclosed To Regulator, Investors And Stakeholders
- Integral Part Of Risk Management System Assessment

Coverage Depth

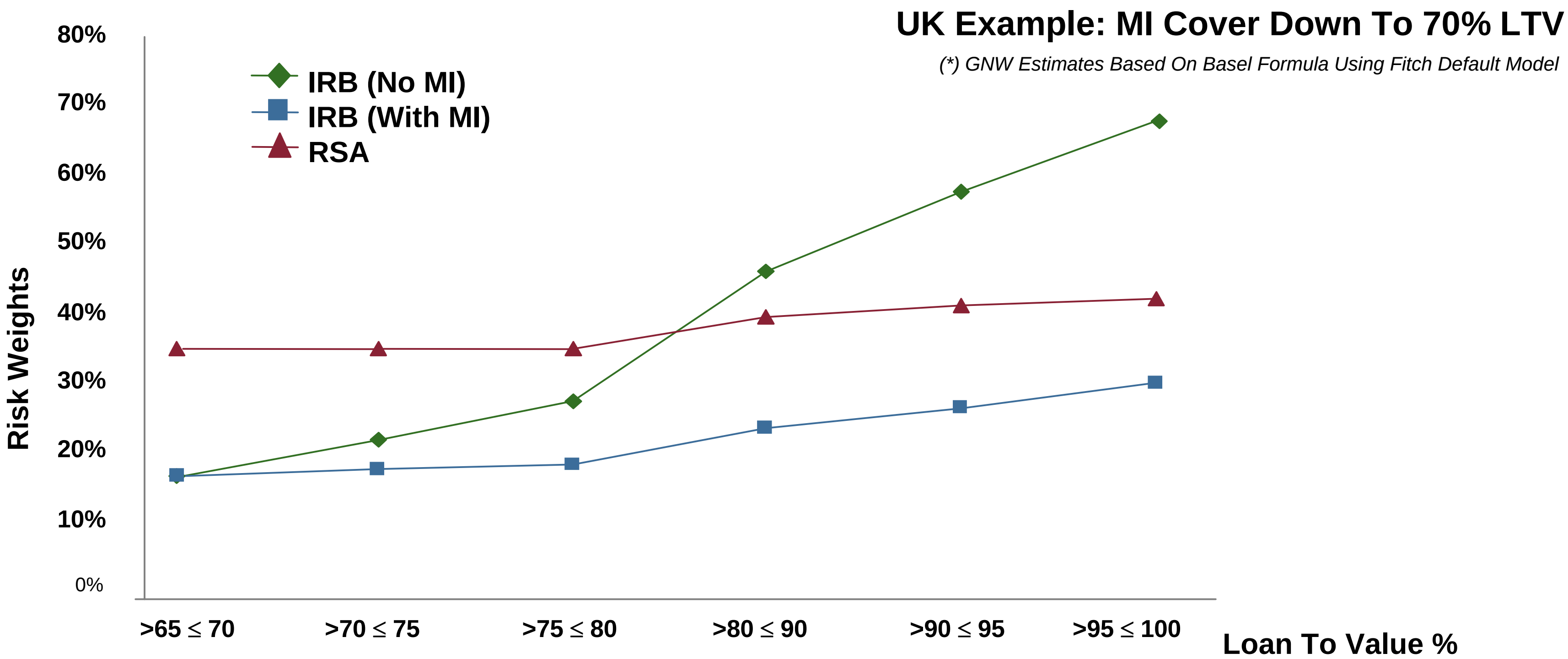
- Non Proportional Recognition Of the Credit Risk Transfer Benefits
- Determination Based On LGD Reduction
- Recognition of all unfunded CRM products provided over retail exposures is limited by the restrictions on the recognition of double default effects in this area
- Likely To Generate Demand For Customized Coverage Options
- Credit Derivative Competition

Capital Relief

- More Individualized
- Impact Highest On Riskiest Exposures
- MI Cannot Reduce Capital To 0%…10% LGD Floor In Transition Period

Rated MI Eligible As CRM Under Basel II … Deeper Cover Encouraged

CRD & Mortgage Credit: RSA vs A-IRB



- **IRB Capital Greater Than RSA Capital For >80% LTV… RSA Banks Will Have Significant Competitive Advantage Over IRB Banks, On Loans >80%**
- **MI Gives Greater Capital Reduction For IRB**

CRD Possible Source Of Inconsistencies With Main Basel II Goals

Pillar I: Implications A-IRB

Credit Risk / IRBA: Increased Flexibility

- **More Flexible Roll Out (Partial-Use Issue Under CRD)**
  - Recognition of Data Limitation, Asset Classes And Business Units Issues
- **Increased National Discretion**
- **More Flexible Minimum Requirements**
  - Recognition Of Different Internal Organisation & Environment

Advantages

For Banks

- < costs Implementation
- Promote internal Model Development
- Facilitate Access to Advanced Approaches

For Supervisors

- Suit for National Specificities
- Suit For Banks Specificities

Drawbacks

For Banks

- > Complexity for Internationally Active Banks
- > Competitivity Issue

For Supervisors

- > Complexity for Cross Border Supervision, Pillar II Implementation and Model Validation

> Flexibility Likely To Undermine Level Playing Field

Pillars II And III - Issues

Basel II Introduces New, More Self-Conscious Regulatory Controls On Bank Operations

Pillar 2
Supervisory Review

Critical Role of Supervisory Review Pillar

Coverage: All Risk Categories

4 Key Principles: Internal Capital adequacy Process; Supervisory Evaluation + Action; Supervisory Ability to Require to Hold Capital In Excess of Minimum; Early Supervisory intervention.

Provides For Use Of Stress Test For Unanticipated Economic Cycle Risk

- New Provision…Reflects Supervisory Nervousness Re: Reduced Capital
- Not An Official Test… But Careful Supervisory Review

Specific Issues To Be Addressed

- Residual Risk From Risk Mitigation Techniques
- Credit Concentrations Risk
- Securitization

Pillar 3
Disclosure

Investors Demand Transparency To Maintain Trust In Management

Solid Corporate Governance Reflected In Clear Comprehensive Disclosure

Forced Disclosure Of Loss Rates (Credit And Operational Risk) Impacts Banks Credit Rating

Risk And Capital Will Be Increasingly Used By The Market As Information Becomes Familiar

Regulatory Approval Will Be Strong Sign Of Market Acceptance Of Information

Pillar II Can Add To, But Not Reduce Pillar I Capital Charges

Basel II: Implications For Mortgage Funding

Capital Relief Less Vital...

Risk Weighting For Res. Mortgages

• Basel I	50%
• Basel II RSA	35%
• Basel II A-IRB	~13% *

Basel II Implications

- Release Approx. 75% Of Equity
- Reduce Incentive For Securitisation As Tool For Capital Relief
- More Business Expectedly Held On Balance Sheet
- But – Any Equity Release Will Enable Multiple Of New Business Compared To Basel I

* Figures: Following Morgan Stanley European Covered Bond Outlook November 05; Assuming PD Of 1%, LGD Of 10% And Strong Originator

Best Execution To Decide

RMBS: “AAA-Tranche-Only”

- Lower Rated Tranches Potentially Issued But Retained By Lender

Or…

Covered Bonds – *The* New Model?

- Funding Motifs Stronger Than Capital Relief
- Cheapest Funding Instrument
- Remains Privileged Asset In Europe (Banks, Asset Managers, Insurance Companies)

Market Expects Mix Of Both

- Different Investors
- Diversification Of Funding Sources
- Opportunistic, Depending on Market Conditions

Basel II & MI: Implications For Lenders

Mortgage Insurance Can Help Banks Compete Under Basel II Guidelines

Why Is This Important?	How Can Mortgage Insurance Help?
✓ Basel II Is Data Driven	Mortgage Insurance Encourages Generation Of Loan-Level Data
✓ Basel II Uses Probability Of Default ("PD") As A Means Of Establishing Capital Levels	The Additional Underwriting, Servicing And Loss Mitigation Rigor Of Private Mortgage Insurance Can Reduce PDs
✓ Basel II Uses Loss Given Default ("LGD") As A Means Of Establishing Capital Levels	Third-Party Mortgage Insurance Minimizes LGD And Reduces Capital Requirements
✓ Basel II Encourages Banking Supervisors To Value Sound Risk Management Principles	Mortgage Insurance Has Facilitated Product Innovation And The Orderly Transfer Of Billions Of Dollars Of Credit Risk Exposures Outside The Banking System
✓ Basel II Requires Timely And Meaningful Disclosures To Be Made About Bank Operations	Mortgage Insurance Provides Transparent Credit Risk Mitigation Well Understood By Regulators And Investors
✓ Basel II Rewards Efficient Operations With Lower Capital Charges	Mortgage Insurance Streamlines Processes And Generates Better Delinquency Monitoring And Loss Mitigation

A Stable Predictable Source Of Credit Risk Protection And Process Expertise

Key Take Aways

Basel II / CRD Provides Structural Mechanism For Global Recognition Of Rated MI…

- MI Lowers Minimum Capital Required Under Both Standardized & IRB Approach
  - 100% Coverage Maximizes MI Benefits Under Standard Approach
  - Deep Cover Valuable In IRB Approach

Basel II / CRD Introduces New Concepts That Present Opportunities For MI To Differentiate Versus Other Alternatives

- Operational Risk… MI Approach Adds Discipline In Lenders Processes … Six Sigma Approach Attractive
- Supervisory Review… MI Provides A Second Opinion… Improved Data Collection & Analytics
- Disclosure… MI Provides Ease And Transparency … Creating More Franchise Value Than A Simple Loss Reserve

Analysts Expect The “Soft” Pillars (2 & 3) To Have A Material Impact

- Best Performers Will Be Required To Hold Less Excess Capital

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