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To: Basel II NPR Public File

From: Mark Van Der Weide and Allison Breault

Date: June 7, 2006

Re: Meeting with Risk Management Association ("RMA")

On June 5, 2006, Board staff met with representatives of the RMA to discuss the interagency notice of proposed rulemaking ("NPR") to implement a new risk-based capital framework based on the Basel Committee on Banking Supervision's ("BCBS") Basel II capital accord ("Accord"). Representatives from the OCC, OTS, and FDIC (collectively, "Agencies") were also present. Before the meeting, the RMA submitted the attached detailed list of questions on the proposal. The meeting followed the outline of the questions presented.

The first group of questions submitted by the RMA focused on the NPR's definition of default. Several RMA members expressed concern that the definition of default in the NPR diverged from the definition of default in the BCBS revised framework published in July 2004 ("Mid-year Text"). The RMA explained that the diverging definition of default in the NPR would require banks with international operations to maintain dual systems because other countries implementing the Accord use the definition of default in the Mid-year Text.

The RMA also expressed concerns about the availability of historical data given the new definition of default and stated that most legacy databases use the 90-days past due standard in the Mid-year Text. One RMA member suggested that the proposal be amended to provide either a materiality test to permit institutions to map old data to the NPR definition of default or greater flexibility within the definition of default. The RMA also requested clarification and expressed concerns about the NPR's treatment of the sale of a wholesale exposure at a 5 percent credit-related loss as an event of default.

The RMA and Agency staffs also discussed the NPR's definition of economic downturn conditions and the supervisory mapping function for converting Expected Loss Given Default ("ELGD") into Loss Given Default ("LGD").

In addition, the RMA members and Federal Reserve staff discussed the NPR's requirement that a bank must use a separate definition of Probability of Default ("PD") that addresses seasoning effects for a segment of non-defaulted retail exposures for which seasoning effects are material. RMA members urged the Board to clarify that the seasoning adjustment applies to all segments of retail exposures for which seasoning is material, not just "unseasoned" retail exposures.

The RMA also discussed with Agency staffs the treatment of securitizations in the NPR. Specifically, RMA members asked for clarification on the internal assessment approach to securitizations and how to determine whether structured financing transactions would be treated as securitizations.

In addition, RMA members and Board staff also discussed the Basel II NPR's treatment of stress testing and the NPR's treatment of repo-style transactions and OTC derivatives.

Moreover, RMA members and Board staff discussed how to calculate a bank's "floor-adjusted" risk-based capital ratio for purposes of the transition rules in section 21 of the Basel II NPR. RMA members expressed concern that the NPR's floor calculations differed significantly in a conservative direction from the Mid-year Text. Specifically, the RMA members stated that the NPR's floor calculations could be punitive for an institution with a high allowance for loan and lease losses. The RMA also questioned how the Agencies would determine whether a 10 percent decline in "aggregate minimum required risk-based capital," as described in the preamble, has occurred as a result of Basel II.

In addition, the RMA raised concerns about the NPR's treatment of equity investments in leveraged investment funds and noted that this treatment differed in a conservative direction from the approach outlined in the Mid-year Text. The RMA also questioned how unfunded equity investment commitments would be treated under the NPR.

Board staff urged the RMA and its members to submit detailed written comments on the proposal.

The list of attendees included:

Agency Representatives	
David Jones	FRB
David Wright	FRB
Robin Lumsdaine	FRB
Roger Cole	FRB
Norah Barger	FRB
Mark Van Der Weide	FRB
Greg Feldberg	FRB
Veronica Sellers	FRB
Allison Breault	FRB
Sabeth Siddique	FRB
Anna Lee Hewko	FRB
Coryanne Stefansson	FRB
William Bassett	FRB
Paul Huck	FRB-Chicago
Stefan Walter	FRB-New York
Brian Peters	FRB-New York
Bill Lang	FRB-Philadelphia

Mark Levonian	OCC
Amrit Sekhon	OCC
Mark Ginsberg	OCC
Ron Shimabukuro	OCC
Kevin Bailey	OCC
Tommy Snow	OCC
Fred Phillips-Patrick	OTS
Michael Solomon	OTS
Jason Cave	FDIC
George French	FIDC
Michael Phillips	FDIC
Barbara Keller	GAO
Clarette Kim	GAO
Michael Hoffman	GAO

RMA Representatives

Pam Martin	RMA
Patrick Furtaw	Countrywide Financial
Gregor MacDonald	Countrywide Bank
Norman Greenfeld	State Street Corporation
Andrew Beise	State Street Corporation
Jim Cypert	Wachovia
Bill Nayda	Capital One
Geoff Rubin	Capital One
John Stewart	Washington Mutual
Thomas Boltja	Key Corporation
John Walter	Bank of America
Jouni Korhoneu	Union Bank of California
Fenton Ayhmer	Citigroup
Lynn San	HSBC
Jodi Richard	HSBC
Chris Hawkes	HSBC
John Roesgen	HSBC
David Coleman	HSBC
Thomas Williams	Comerica
John Mingo	Promontory Financial Group
Joseph Lyons	JPM Chase
Gregory Devany	JPM Chase
Jim Colton	JPM Chase
Michelle Rosenthal Hubertus	JPM Chase

RMA Capital Working Group
NPR Questions for the Regulatory Agencies
Submitted by RMA on May 23, 2006

Overview:
RMA appreciates the opportunity to submit this document to help facilitate discussion with the regulatory agencies at a meeting scheduled for June 5 in Washington, D.C. to discuss the NPR. Industry participants do not intend to discuss policy related issues, but instead seek guidance and clarification. Clarification around the intent of the NPR is requested in five broad categories – 1) Definition of Default; 2) LGD; 3) EAD; 4) Seasoning; and 5) Securitization -- with specific questions about each issue detailed below. Additional questions surrounding overall implementation issues are included, as well as questions that may be answered with a simple yes or no, perhaps in writing.

The RMA Capital Working Group strongly supports the goal of aligning regulatory capital more closely with underlying risk. We have been actively involved in the process to reform the 1988 Basel Accord since inception and believe that much has been accomplished toward the advancement of risk management practices through the reform process. RMA is hopeful that the implementation of Basel II can be structured to encourage and enhance continued industry innovation and that the regulatory agencies continue to recognize the benefit that diversity of practice within the industry provides. Diversity of practice must be supported, while homogenization should be discouraged, as it will stifle innovation and possibly raise the level of systemic risk within the financial system.

Definition of Default Issues: (pp. 109-112).

1. Some institutions use a definition of default that is broader than the definition contained in earlier guidance or the NPR. Is it acceptable to use a more inclusive definition of default? For example, could a bank use any of the conditions in the NPR *or* 90DPD for wholesale? Similarly, for retail mortgages, for example, can we use 180 DPD *or* any of the other conditions? From a data management perspective, a DPD standard may be identical to a non-accrual standard (e.g., the bank places any loan that reaches 90DPD on non-accrual status). However, variability in the timing of non-accrual status (in the days after the 90DPD flag is reached) may make it both more relevant and easier to use the 90DPD flag (e.g., when using monthly data) rather than the non-accrual flag, when collecting and analyzing historical data. Can you clarify that, where the general intent and practice is to have a particular DPD flag be equivalent to a non-accrual flag, the DPD flag is acceptable for reference data purposes. Would there be any difference in the acceptability of this practice depending on the product type?

2. Previous guidance has included a *materiality* clause for data capture relating to charge-off and default. For example, minor amounts were deemed as administrative and not required to be parameterized. Thus, forgiveness of a $100 fee on a $10 million loan would not be counted as a default. Is this still the case? Can a non-material charge below a certain threshold be excluded as before? The materiality question applies to both wholesale and retail credits.
3. Regarding the changes to the definition of default associated with a credit-related loss of 5% or more on sale (wholesale):
    a. If a bank sells partial ownership at a discount greater than 5%, is the remaining balance treated as a default? Even if it is still accruing?
    b. How would a bank determine a credit related discount as opposed to a market-risk related discount?
    c. Could you clarify the treatment of sales at a discount of SNCs? For example, would the sale at a 6% discount by the agent (or any other participant in the credit) require all participants to recognize a default for reference database purposes. If the loan is still accruing?
    d. Would sale at a 6% discount trigger cross-default "provisions" with respect to other loans of the obligor – again, for purposes of recognizing "default" in the reference database?
    e. For the obligor whose individual loan contracts contain specific legal prohibitions against initiation of cross-default treatment, what would be the effect of the sale at a 6% discount of one of the obligor's loans? Such language may be most likely in the case of a secured loan such as CRE.
4. With respect to the sale of retail loans, the NPR (p. 112) does not require loan sales at a discount to be recognized as defaults. Please clarify that the language on p. 112 that goes beyond this exclusion (to the need "to assess carefully the impact of retail exposure sales") deals only with the need to appropriately establish a reference database. For example, such a reference database might appropriately exclude sub-prime assets sold at a discount that did not involve a significant credit quality decline prior to sale. In this example, the sale might have involved a discount related mainly to differences between the seller's and the buyer's appetite for risk.
5. In general, what are the agencies' views regarding instances in which there may be significant differences between the GAAP definition of default and the NPR's definition of default, especially with regard to the sale of loans at a discount? Are there specific concerns with regard to the Interagency Guidance on Certain Loans Held for Sale, issued March 26, 2001, which does not suggest that sales at a discount be treated as default? Are the agencies concerned about the negative effect on secondary loan markets and bank liquidity of the proposed treatment of sales at a discount?

LGD/ELGD Issues: (pp. 116 to 121).

1. Beginning on page 116, the NPR discusses the determination of LGD within "categories" and "sub-categories", along with the new supervisory LGD mapping function. Could you explain the intent of the whole section, and, more specifically, the analytics behind the supervisory mapping function?

2. Can the supervisory formula be mixed with internal data at the subcategory level? For example, can an institution use internal data for 80% of its exposures and use the supervisory formula for the 20% where it does not have robust data? Put another way, please clarify that, so long as an appropriate sub-sub-category is defined, this is not an "all-or-nothing" approach. If an institution needs to use the supervisory formula for one subcategory, is it required to use the supervisory formula for everything within that product category? If the answer is "yes", can the agencies explain why?
3. The LGD must "capture accrued but unpaid interest." We request clarification that unpaid interest and fees at default are captured in estimated EAD. In estimating LGDs, the observed LGD in the reference database would then be the actual exposure at default (including unpaid interest and fees) less appropriately discounted recoveries and expenses. Please refer to question 2 below, under "EAD issues."
4. The NPR maintains a 10% LGD floor for mortgages but also maintains a floor based on the ELGD transformation function. How will these two requirements be reconciled?
5. The discount rate for recoveries should be "appropriate to the risk of the exposure." Please clarify; examples would be helpful.
6. For retail, LGD, unlike PD, can be estimated at the loan level. Would you clarify whether this means that the bank can or cannot define retail segments to be based on ranges of PD and LGD rather than ranges of risk characteristics that are determinants of PD and LGD?
7. Banks must segment defaulted assets according to characteristics that are predictive of current loss and recovery rates. Please clarify the intent of this requirement, given that the capital requirement for the defaulted asset will be either the capital requirement given its segmentation just prior to default or a flat 8% of its post-default amount after write-down.

EAD Issues: (pp. 123-125).

1. The NPR states that the EAD (for the "on-balance-sheet" portion of the credit) is the carrying value. What is meant by "carrying value?" Please clarify that deferred fees would be included within the carrying value. Also confirm that purchase premiums or discounts would be included within carrying value as per GAAP.
2. Suppose EAD is estimated properly as no less than current balance, but the actual exposure at default is less than estimated EAD due to pre-default amortization or pay-backs in the case of asset-based lending. Please clarify that the effects of such reductions in actual EADs below current carrying value are reflected in the following manner: LGD should be stated as the ratio of the actual exposure at default, less discounted recoveries and expenses, to (in the denominator) the estimated exposure (which is higher than the actual exposure at default). Is this the approach you intend for handling such cases via a lower LGD rather than a lower EAD?

3. Under what conditions can a through-the-cycle estimation of EAD be used as the downturn EAD? Is there a specific standard being considered for concluding that EAD (or LGD) is not materially cyclical?
4. Do the downturn EAD and LGD estimations have to cover the same time period?

Seasoning Issues (pp. 115-116):

1. Please clarify that it is only default frequency (i.e., the estimation of PD) that is being tested for seasoning (age) effects.
2. At what level of granularity must the seasoning materiality test be imposed? The NPR states that it must be at the segment level (p.20) and also implies that it can be either the segment or exposure level (p. 115). Are you considering simply reaching a consensus regarding which specific retail products involve seasoning effects?
3. Do you have further specifics regarding the nature of the materiality test?
4. Please define annualized cumulative probability of default (ACPD). How is the annualization calculated (e.g., via use of the time formula or via simple division by the number of years in the remaining-life estimate)?
5. Please clarify whether ACPD would be applicable for all Age buckets, for a product that is sensitive to Age, not just the "unseasoned" bucket discussed in previous drafts.
6. Since calculation of ACPD requires a remaining-life-of-loan estimate, is this effectively a requirement to calculate M for all Retail exposures? If so, since M is capped at 5 years for Wholesale, would a similar cap apply for ACPD for Retail?
7. Do estimating expected remaining life and "potential changes to expected life" require through-the-cycle prepayment estimates or current prepayment estimates? Please clarify (with regard to the last sentence in the last paragraph on p. 115, ending at the top of p. 116).
8. Must ACPDs be measured via the simple TTC mean of observed cumulative default frequencies in a segment or may alternative estimation techniques be used (e.g., via the use of state transition models that estimate ACPDs based on segment risk characteristics).

Securitization Issues:

1. Significantly past due or defaulted – On pages 454 and 455 the Draft NPR states that:

   "The ABCP program's underwriting policy must establish minimum asset eligibility criteria that include the prohibition of the purchase of assets that are significantly past due or defaulted, as well as limitations on concentration to individual obligor or geographic area and the tenor of the assets to be purchased."

   Please clarify that, with respect to qualification of an ABCP program, this rule allows the use of widely accepted industry standards for "significantly past due" or "defaulted" for the particular ABCP underlying asset class.

2. Determination of credit enhancement levels based on rating agency stress test factors – On page 453 the Draft NPR states that:

   "Where the commercial paper issued by an ABCP program has an external rating from two or more NRSROs and the different NRSROs' benchmark stress factors require different levels of credit enhancement to achieve the same external rating equivalent, the bank must apply the NRSRO stress factor that requires the highest level of credit enhancement."

   In the event that published criteria are not available for a specific underlying asset, please clarify whether banks may use internal criteria that follow NRSRO criteria for *similar* products, provided that the internal criteria are reviewed by and acceptable to supervisors.

3. Liquidity Facilities provided to SPVs. The liquidity facilities are usually *pari passu* with the AAA notes in the securitization. Often there is a AA tranche below the AAA tranche. In this case the rating of the liquidity facility can be inferred from the AA tranche. In a transaction where there is not a rated tranche below the AAA tranche, how should RWA be calculated? Please clarify whether, so long as the liquidity facility is *pari passu* with a AAA rated tranche, that a AA rating may be inferred for such a facility, even though no lower externally-rated tranche exists.

4. Structured financings (pp. 165-166). The discussion on these pages indicates that a structured financing of income producing property is not to be treated as a securitization because the "underlying exposure would be real estate." Please clarify that if a bank owns a mezzanine tranche of a CMBS securitization this *is* to be treated as a securitization. Could you give an example of a structured financing that *would* be treated as a securitization?

Other Issues:

1. Legal Entity Issues: The NPR states (p.104) that, with regard to a separate subsidiary of a Basel II institution, reference data must be "representative of its own credit and operational risk exposures." Must the reference data be separate? What are the options for using external data? Does each legal entity have to have a customized quantification process? Please clarify, for example, the case in which the banking firm estimates PDs, LGDs, and EADs at the loan level for all products, using a reference data set for each product and/or segment that is all-encompassing (includes historical data from all legal entities). In such a process, the risk parameters for loans at each entity are estimated based on the specific risk characteristics of the loans in that entity, but with estimating function(s) that are based on all possible historical data.
2. Stress Testing: It is unclear how the requirement for stress testing the entire system (p. 27) relates to the requirement for downturn or stressed parameters for each asset segment. Does this imply, for example, that regulatory Pillar 1 capital requirements should be determined by any/all of these stress scenarios over any time period, rather than by the Basel II credit risk models? Or is this simply guidance related to how the bank must examine and manage its overall regulatory

capital position (essentially a Pillar 2 or supervisory issue, not a issue with regard to formal minimum capital requirements) Could we generally receive more clarification with regard to the discussion of stress testing on pp. 145-146?

3. OTC Derivatives (p. 239 and p.437): Under Section V.D "Unsettled Securities, Foreign Exchange, and Commodity Transactions" of the NPR, it is stated that "one-way cash payments on OTC derivative contracts" are excluded from the scope of this section. Does that imply that OTC derivatives exposures which involve a **two-way** cash payment (e.g. FX forward, cross currency swap, commodity swap, etc.) are included in the scope of the rules for "Unsettled Securities, Foreign Exchange, and Commodity Transactions"? Also under "Risk-Based Capital Requirement for Unsettled Transaction" it is stated that unsettled repo-style transitions should be treated as all other repo-style transactions. However for disclosure purposes, will banks be required to separately report unsettled repo-style transactions?
4. Double Default:
    a. For an entity to qualify as an eligible double default guarantor, the entity must have (p. 232):

    > *"a bank-assigned PD that, at the time the guarantor issued the guarantee or credit derivative, was equal to or lower than the PD associated with a long-term external rating of at least the third highest investment grade rating category"*

    Please confirm that "a long-term external rating of at least the third highest investment grade rating category" equates to an A- rating, which would make it consistent with the July 2005 BIS Trading Book Review document.

    b. (pp. 231-235). Please clarify whether the bank can simply rate the guarantor -- rather than rate both the guarantor and the obligor -- if the bank finds it more convenient to simply use the substitution approach.
5. EAD for Counterparty Credit Risk: As per Section V.C.2 "EAD for counterparty credit risk" (p. 196), in order for a transaction to be considered a "repo-style transaction", it must be:

    > *"executed under an agreement that provides the bank the right to accelerate, terminate, and close-out the transaction on a net basis and to liquidate or set off collateral promptly upon an event of default (including upon an event of bankruptcy, insolvency, or similar proceeding) of the counterparty, provided that, in any such case, any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions"*

    However, the treatment for repo-style transactions which are not executed under an agreement is still unclear. Are banks required to use the Adjusted LGD approach for these transactions (similar to the 2003 ANPR guidance) or can the Internal Models Methodology be applied, as depicted in Figure 2 on p. 196?

For example, in markets where buy/sellback transactions are traditionally not required to be executed under an agreement, are we required to calculate counterparty credit risk capital for these transactions and if so, by which approach?

6. Internal Models Methodology for counterparty credit risk.

a. Under Section V.C.4 "Internal Models Methodology" p.210, it is stated that:

"The internal models methodology requires a risk model that captures counterparty credit risk and estimates EAD at the level of a 'netting set'."

An internal model may calculate average exposure at the netting set level but apply collateral at the collateral contract level. When this application of collateral is performed across netting sets, exposure for all netting sets will have been floored at zero so there will be no "netting" benefit from applying collateral across netting sets.

Operationally, can banks apply collateral at the collateral contract level as well as reporting EAD at the collateral contract level? Allocating collateral back to the netting set level seems arbitrary and has no impact on the overall EAD results.

b. Under Section V.C.4 "Collateral agreements under the internal models methodology" p.216, it is stated that:

"In no circumstances may the bank take into account in EAD collateral agreements triggered by deterioration of counterparty credit quality."

If the collateral held today was posted as a result of a credit rating deterioration trigger in an existing collateral arrangement, please confirm that the internal model can still include this collateral in the EAD calculations.

c. Under Section V.C.4 "Alternative Models" p.219, it is stated that:

"The proposed rule allows a bank to use an alternative model to determine EAD, provided that the bank can demonstrate to its primary Federal supervisor that the model output is more conservative than an alpha of 1.4 (or higher) times effective EPE. This may be appropriate where a new product or business line is being developed, where a recent acquisition has occurred, or where the bank believes that other more conservative methods to measure counterparty credit risk for a category of transactions are prudent."

Would the Current Exposure Methodology (CEM) be considered a more conservative "alternative model"?

With the frequent innovation in the derivatives marketplace and introduction of new products, system limitations will often result in a number of transactions which cannot be handled by an existing "primary" internal model at a given time. Could CEM as an "alternative model" be used for these?

7. Qualifying test for QREs. There being no language regarding such a test, may we assume that it is no longer necessary?

8. Small business lending treated as Retail (p. 163). Can the requirement that such small business loans be less than $1 million be satisfied by the internal requirements of the business line, or must we examine each individual loan in the business line and take out those that are over $1 million in size, even if modestly over the limit?

9. Treatment of residential loans at the loan level (top of p. 162). Multifamily loans of under $1 million would be treated as "retail" mortgages, even though the industry typically rates and effectively "manages" such loans on an individual loan basis. This choice of credit risk model is consistent with the economics of such loans. However, residential mortgages "managed" on an individual basis would be characterized as wholesale and subject to the wholesale credit model, which has asset-value-correlations inconsistent with the economics of residential mortgages. Please clarify that "managed on an individual basis," in the case of residential mortgages, does NOT refer to the practice of estimating for internal purposes PDs and LGDs at the loan level via the use of logistic regressions based on historical data.

10. PD and LGD estimating procedures for retail segments or obligor or facility rating buckets for wholesale. At several points, the NPR seems to be conflicted on appropriate procedures for estimating risk parameters for a defined segment. For example, on p. 119, in the context of ELGD estimation, the NPR states:

    "*For example, given appropriate data, the ELGD* ***could*** *be estimated by calculating the default-weighted average economic loss per dollar of EAD given default for exposures in a particular loss severity grade or segment observed over a complete credit cycle.*"

    At another juncture (p. 114) the NPR uses the word "would" instead of "could" (first paragraph under the section heading, second sentence). The sentence suggests that the *only* way to measure PD is simply by using the observed through-the-cycle default frequencies for the rating bucket or segment as a whole. Does this language preclude the use of loan-level logistic regressions or other loan-level devices (such as KMV EDF estimates within a rating category) to estimate the mean through-the-cycle PD or ELGD for a rating bucket or retail segment?

11. Floor calculations for Prompt Corrective Action purposes (p. 99). The discussion of calculating the RBC ratio for PCA purposes needs clarification. How is a "floor-adjusted" risk-based capital ratio calculated? For example, suppose the bank's total actual RBC ratio is 12% under the old Accord. Please clarify that, if the minimum absolute level of required total capital under the Basel II approach declines below the level required under the old Accord, the capital ratio to be computed for PCA purposes would, in any event, rise about 12%. It would help to give an example of how the "floor-adjusted" RBC ratio would be calculated in a case where the floor is binding and in a case where it is not.

12. 10% aggregate capital decline. Please clarify the numerical definitions of "aggregate minimum required risk-based capital" (p. 84) both under the existing rules and under the proposed NPR framework, so that the industry and the public can understand quantitatively what is meant by the 10% decline in aggregate minimum required risk based capital (in the context of "a numerical benchmark for evaluating and responding to capital outcomes during the parallel run and transitional floor periods that do not comport with the overall capital objectives outlined in the ANPR").

13. Clarification of the basis for the parallel run and the transition periods (p. 100). We interpret the NPR to mean that if Basel 1A is implemented prior to the parallel year then Basel 1A will be the basis for comparison. A question arises around what exactly would be meant by implementation of Basel 1A. For example, do you mean that if a *final* Basel IA rule is passed that it would constitute the floor, even if implementation of Basel 1A took place after the parallel year or after one or more of the phase-in periods? Would passage of an NPR constitute Basel 1A implementation for these purposes?

14. Equity – What is the treatment of an investment fund that would not meet the literal investment fund definition due to the existence of material liabilities? It would not seem to fall under the equity/investment fund rules, nor would it meet the definition of a securitization exposure, because it is not "tranched."