Date: September 13, 2004

To: U.S. Banking Agencies

From: The RMA Capital Working Group[1]

Re: The June 2004 Basel II Framework

This memorandum is intended to highlight several implementation issues that arise from the June 2004 Basel II Framework document. Some of these issues were discussed at the Basel II Forum held in New York on July 22, 2004. After that meeting, some U.S. agency staff members suggested that the RMA Capital Working Group provide a formal discussion of these issues in advance of the late-2004 U.S. release of its Draft Supervisory Guidance for Retail Credit Risk.

To begin, we wish to thank the U.S. agency representatives that attended the Forum, as well as those agency staff that have discussed these issues with us in the weeks after the Forum. These discussions have clarified several points within the Framework and have given us confidence that the U.S. agencies will be flexible and pragmatic in their interpretation of the requirements of the Framework. As just one example of this desirable flexibility, note that many of our member institutions are in the process of improving upon their internal procedures for estimating PDs, LGDs, and EADs. Other institutions, especially in the retail arena, are setting up these estimation procedures for the first time and have been hampered somewhat by the changing structure of the Basel framework since the publication of CP3. For example, only with the publication of the Framework this past June has it become clear that expected LGD ("ELGD"), interpreted previously to mean the through-the-cycle default-weighted LGD, will <u>not</u> be used within Basel II, except in the case in which LGDs are shown to be non-cyclical. We are therefore pleased that the U.S. supervisors have indicated that the 3-year "use" test would not necessarily be interpreted to mean that, in order to qualify for the start of the parallel calculation period in the U.S. (beginning in January 2007), we would need to have been using these PD, LGD, and EAD estimates within internal risk management practices by the beginning of 2004.

It is in this spirit of cooperation that we present the discussion below. Please note that each of our member institutions would rank order these issues differently, given the uniqueness of their own portfolios. In addition, individual institutions will be raising other concerns that are of particular importance.

1. <u>Definition of default</u>. We are encouraged that the supervisors' discussion at the July 22 New York Forum indicated a desire to have default definitions reflect industry

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[1] <u>The Capital Working Group of RMA — The Risk Management Association</u> consists of senior risk management officers at large banking organizations responsible for the measurement of risk and the determination of Economic Capital. The names of the institutions represented on the Capital Working Group, along with staff members contributing to the preparation of this memorandum, are shown in an Appendix. Individual banking organizations that are members of the Group may be responding separately to the Framework and may hold opinions regarding Basel II that differ from those expressed in this paper.

practices (including the FFIEC definition for retail assets). We hope the forthcoming retail supervisory guidance will therefore interpret paragraph 453 of the Framework in flexible fashion. In particular, we believe it would be inappropriate to treat any single element in paragraph 453 as triggering non-compliance with the reference definition. Rather the appropriate treatment of the reference definition of default should reflect the views we expressed in our response to the ANPR and the draft supervisory guidance for commercial credits:

"We wish to point out that the proposed AIRB definition of default in the ANPR does not comport with past accounting or risk measurement practice. For this reason, it is likely that this standard could only be met on a going-forward basis. More importantly, we do not believe that best-practice should involve any significant difference between the definition of default for, on the one hand, accounting and bank reporting purposes, and, on the other hand, measuring PDs and LGDs. Indeed, the more stringent is the supervisor's definition of default for capital purposes, the higher will be measured PDs and the lower will be measured LGDs. The net effect, although slight, will be in the direction of lowering measured (required) regulatory capital. Meanwhile, the bank would have to put in place a completely separate set of "capital-only" accounting procedures, which would be costly and, ultimately, would have very little effect on measured soundness. Thus, the AIRB definition of default should be consistent with current practice, not a definition unto itself."

2. Qualification test for revolving retail exposures. To qualify for the 4% asset-value-correlation ("AVC") applied to qualifying revolving retail exposures ("QRREs"), the AIRB bank must demonstrate that its credit card product exhibits a low loss-volatility over time relative to the long-run average loss rate (paragraph 234(d)). This requirement is problematic for two reasons. First, the paragraph implicitly assumes that volatility in loss rates over time is indicative of the risk inherent in the current portfolio (the underlying assumption is that, on a bucket basis, the true underlying loss distribution is stable over time). This assumption may be inappropriate for a variety of reasons, including changes over time in underwriting standards, changes in account management practices, and changes in the degree of uniformity of state-by-state personal bankruptcy laws. Second, there would need to be a standard of comparison. For example, if a bank computes, for credit cards, the ratio of the standard deviation of its loss rates (over time) to its historical mean loss rate, to what other product should this ratio be compared? Paragraph 234(d) implicitly suggests that the comparison standard should be "other retail". Unfortunately, this category encompasses a wide variety of credit products, including unsecured term loans, auto loans, etc. Moreover, each bank's "other retail" portfolio will fundamentally differ from other banks' portfolios – so the standard of comparison may differ substantially across banks.

For these reasons, it may be helpful if the QRRE qualification test is met on an industry wide basis. In coming months, a group of RMA banks that issue credit cards will be investigating this issue, and we would be pleased to work with agency research and supervisory staff on the matter.

3. EADs for amortizing loans and certain other credits. The Framework places a floor on EAD equal to current outstanding balances. This floor may be inappropriate for amortizing loans near the end of their term, since monthly payments may consist mostly of principal repayments. Therefore, any default over the one-year horizon may likely

involve unpaid principal and interest that are lower than at the start of the period. In the case of lines of credit, historical data may show that, for some segments, borrowers actually pay down outstanding balances prior to default (in an effort to preserve credit standing). Still another case in which AIRB banks possess data showing EADs less than current balance are some forms of asset-based lending. If data support EADs less than 100% of current balances, the Basel II treatment should be accommodating for the particular bucket involved – that is, this issue should be essentially a Pillar 2 matter. Perhaps this issue is mainly one of interpretation. That is, the EAD floor, if applied at the broad product level (e.g., all commercial loans or all mortgages), would be much less of an issue than if applied at the segment level.

4. Minimum LGD for mortgages of 10%. Paragraph 266 indicates that, during the transition period (2008-2010 in the U.S.), the minimum LGD for residential mortgages will be 10%. During the transition period, this floor will be re-examined. Clearly, the assigned LGD will depend critically on the current loan-to-value ratio of the loan (which will depend, in turn, on the original LTV, past housing price increases, and past principal repayments). For low LTV loans (e.g. 70% LTVs or lower), the "stress" assumptions would have to be severe to result in positive LGDs, let alone 10% LGDs. For this reason, we ask regulators to be receptive to new data concerning stressed or downturn LGDs and, if the data are persuasive, to consider lifting the arbitrary LGD floor prior to implementation.[2] Note also that, as in the case of the floor on EADs, this issue is much less important if the floor is applied at the product level rather than at the segment level.

5. Clarification on language dealing with guarantees. We seek clarification regarding several issues surrounding financial guarantees.

a. Irrevocability. Paragraphs 140 and 484 indicate that guarantees cannot be cancelable by the guarantor. Some guarantees, however, provide for the guarantor to cancel with 60 days notice. Such clauses typically are coupled with clauses permitting the lender to call the loan upon receipt of notice to cancel the guarantee. In such a circumstance, if the obligor should default upon notice of call, the guarantee would still be in effect and would be exercised. We seek clarification that, when these two types of clauses exist together in a financial guarantee, paragraphs 140 and 484 would not cause the guarantee to be rejected as an eligible risk mitigant.

b. Conditional guarantees. Under the Standardized approach, paragraph 190 indicates that: "The bank must have the right to receive any such payments from the guarantor without first having to take legal actions in order to pursue the counterparty for payment." Under the AIRB approach no such language exists and, further, paragraph 484 states that clauses specifying "conditions under which the guarantor may not be obliged to perform (conditional

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[2] As an example, note that the influential paper by Calem and Follain (FRB, October 2003) established for 70% LTV loans a stressed loss-given-foreclosure ("LGF") rate of approximately 21%. The implied stressed LGD was 16%, based on the assumption that 25% of defaulted loans were "cured" (became current) or prepaid before foreclosure took place. Current data suggest that cure/prepay rates are on the order of 2-3 times the 25% assumption used in the Calem-Follain paper, implying a proportionately lower stressed LGD. We are conducting further research to establish *stressed* cure/prepay rates. We intend to share this information with supervisors as soon as it is available.

guarantees) may be recognized…" In this context certain guarantees, such as SBA guarantees, may require lenders to first seek satisfaction from the obligor before the guarantee can be fully realized. Note also that SBA guarantees cover most, but not all, of the amount outstanding. We seek clarification that, at least in the context of AIRB banks, such guarantees will be recognized for risk mitigation purposes. Note that, as a practical matter, AIRB banks are likely to adjust either the LGD or the EAD of a partially-guaranteed loan, rather than the PD.

c. Requirement for rating of obligor and guarantor. Paragraph 481 states that the bank must assign an obligor rating to the borrower as well as to the guarantor at the outset of the credit and on a continuing basis. In the case of a 100% guarantee, the regulatory capital calculation would not involve using the PD of the obligor (i.e., the PD of the guarantor would substitute for the PD of the obligor). Indeed, in some cases it is not practical for the bank to assign a rating (or PD) to the obligor (e.g., when the obligor is an individual) when there is a 100% or near-100% guarantee (e.g., for guaranteed student loans). Clearly, when the guarantee is significantly less than 100%, there is a need to assign a PD to the unguaranteed portion of the credit. We are concerned that the requirement of Paragraph 481, if applied without exception to all guarantees, would lead AIRB banks to develop scoring/rating procedures for some obligors for which the score/rating would have no regulatory capital or internal economic capital use. We seek confirmation that the general spirit of Paragraph 481 will be implemented as a guiding principle rather than as an inflexible prescription.

6. Clarification on bucketing of retail loans. We seek clarification regarding the proper "bucketing" of a loan into one of the retail product categories (versus identification as a commercial loan). Two examples suffice:

a. A credit card issued to a small business, but with the business partner contractually responsible for repaying the credit. Paragraph 234 would seem to preclude such a credit card account being treated as a Qualifying Revolving Retail Exposure (QRRE), since such credits are supposed to be to individuals only. However, as a practical matter, AIRB banks would extend the credit based on the creditworthiness of the individual if the individual signs the obligation jointly and severably (i.e., the bank would score the credit using the characteristics of the individual, and would manage the account as if it were a credit extended to the individual).

b. A revolving line of credit to a small business, using the partner's residence as collateral. Paragraph 232 indicates that such lines, if less than €1 million, may be treated as retail credits, but the paragraph provides no further guidance. In the example cited, it may be appropriate for the AIRB bank to treat the line as a Home Equity Line of Credit (HELOC), if the bank is employing scoring (rating) and management techniques applicable to such lines of credit made directly to an individual. Note further that, at low PD levels, there may be a significant impact on required regulatory capital associated with appropriately bucketing the loan into the HELOC category -- especially if Basel later reduces the AVCs for HELOCs below those used for first mortgages.

We seek clarification that, in the two examples above, or in similar cases, the prevailing rule of thumb will be that proper bucketing of the credit will depend primarily on the manner in which the bank makes credit decisions, prices the credit, and manages the credit once it is booked.

7. The Framework's limit on the amount of the ALLL that can count as Tier 2 capital. In the U.S. (and possibly in some other Basel countries), single-family residential ("SFR") lending and credit card lending could be handicapped by the Framework's treatment of the [ALLL minus EL] test. Reserves for SFRs, as is the case for other business lines, are accounted for roughly in proportion to current expected loss rates on the SFR portfolio. Over the last several years, even with the recent recession, such expected loss rates have been low. As a result, mortgage businesses have tended to hold their economic capital in the form of real equity, not in the form of high reserves. Basel LGDs, however, would likely be a multiple of current economic LGDs, which, under the Framework, could lead to a "shortfall" in the ALLL minus EL calculation. Fifty percent of this shortfall must be deducted from Tier 1 capital and 50% from Tier 2 capital, for regulatory capital purposes. Even though the market views the *sum* of Tier 1 plus the ALLL to be a cushion against unexpected losses, the mortgage business lines would be penalized for holding their capital in the form of equity rather than reserves.

In credit card lending, accounting practices also do not permit high reserves.[3] In particular, U.S. banks are not permitted to establish a loan loss reserve for the undrawn portion of lines. Moreover, some banks do not reserve for accounts held for securitization (which are carried at fair value or LOCOM). Most importantly, auditors may require that the ALLL for outstanding card balances be computed over a shorter horizon than the one-year horizon associated with EL. As a consequence, [ALLL – EL] may be in a shortfall for banks engaged in the card business -- especially, for those banks securitizing some portion of their card accounts. Banks that engage in the card business therefore may hold capital in the form of equity, not reserves, against the risk of such products -- and the market does not distinguish between these two forms of capital. Similar problems may arise within other retail lines of business such as HELOCs and home equity term loans.

We suggest that the inequities associated with the [ALLL-EL] test may be alleviated through country-specific treatment of the ALLL-EL computation. That is, where GAAP does not permit there to be a positive ALLL-EL computation, the supervisor might first make a determination as to the sufficiency of overall bank capital. Where no capital deficiency exists, the supervisor could then treat the ALLL for capital purposes as if it equaled EL. Still another method to treat the problem would be for supervisors to permit an EL calculation (only for purposes of the ALLL-EL test) in which

[3]Although accounting practices do not permit high reserves, the bank still has a market capital requirement that must be met with another form of equity. Thus, the ratios of Tier 1 to Total Capital at the large mortgage and card specialists in the RMA group are *significantly* higher than for large full-line banks. It would be inequitable to reduce the amount of recognized Tier 1 at these institutions because of accounting procedures.

the EL calculation uses the same horizon and assumptions as are built into the accounting treatment of the ALLL.[4]

The RMA Capital Working Group appreciates this opportunity to engage in constructive dialogue with U.S. regulators. We remain staunch supporters of the ongoing process to update the industry's capital regulations and to move internal risk measurement and management procedures toward ever better practice.

[4] There are at least three types of differences in assumptions that exist between the GAAP treatment of provisions and the EL computation as required by Basel: a) GAAP may require a shorter time horizon; b) GAAP may not include all of the economic expenses associated with default and recovery, such as certain foreclosure and REO expenses, and the time value of money; and c) GAAP provisioning incorporates current expectations regarding LGDs, not stressed LGDs.

Appendix

Institutions in the RMA Capital Working Group:

Bank of America	Bank of Montreal
Bank of New York	Capital One
CIBC	Citigroup
Comerica	Discover Financial Services
HSBC/North American Holdings	JPMorganChase
KeyCorp	MBNA
PNC Financial Services Group	RBC Financial
State Street	SunTrust
Union Bank of California	Wachovia
Washington Mutual Bank	Wells Fargo

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