"Paul Calem"
<pcalem@verizon.net>
12/14/2004 03:53 PM

Dave:

As someone close to the original development of the mortgage risk weight function, I have two concerns about some aspects of implementation in the proposed retail supervisory guidance. These are:

1. The asset correlation parameter was calibrated by "reverse engineering" an asset correlation based on estimates of PD, LGD, and BBB-plus credit value-at-risk capital. The derfinition of default used for the PD estimates was a 180-day definition. Allowing banks to use an earlier definition of default will result in assignment of too little capital.

2. In addition, PD estimates were based on annualized, 10 year default frequencies for newly originated loans. For a portfolio that is not segmented by age and has a stable mix of loan ages, this should correspond to the observed one-year PD. For banks that segment by age, one-year PD estimates for seasoned loans will tend to be on the high side on average, relative to what would be consistent with the original calibration of the risk weight function, but capital should not be too far off (the higher average PD will be balanced by lower capital due to finer segmentation). One-year PD estimates for new loans will be much too low. However, it is not clear that the solution proposed in the guidance--to calculate an annualized PD for the expected life of the loan, is the correct solution. In the first place, it bears little relation to the original calibration of the risk weight function, which imposed a 10-year horizon for calculating annualized PD. In the second place, banks will have to begin accumulating data on expected life on top of their other data requirements. In the third place, banks for now will most likely end-up be relying only on recent information from high prepyament periods that may lead them to greatly underestimate average expected life. They then would have to hold punishing amounts of capital. Why not just impose a requirement that for unseasoned loans (say under 18 months, or maybe 24 months), banks have to hold some weighted average of the capital calculations for the unseasoned and the next most seasoned bucket? For instance, if the formula indicates 1 percent capital after year 1 and 0 percent for new loans (due to zero PD the first year), require banks to hold 0.80 oercent on new loans. Perhaps rather than being set arbitrarily, the weights could be based on estimates of long-run, average prepayment rates in the first year (from a source like LoanPerformance, which OTS might have access to) along with some reasonable discounting (for example, 5 percent) of next year's capital. Thus, 15 percent average prepayment and a 5 percent discount factor would justify the 80 percent weight.