



January 25, 2005

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Re: Docket No. OP-1215, Internal Ratings-Based (IRB) Systems for Retail Credit Risk for Regulatory Capital

Dear Ms. Johnson,

The Conference of State Bank Supervisors (CSBS) as the national association representing the 54 state banking agencies that charter and regulate approximately two thirds of the nation's commercial banks, is pleased to comment on the proposed supervisory guidance on IRB Systems for Retail Credit Risk (the Proposal.) The Proposal reflects considerable effort and evolving comprehensiveness that should ultimately provide both bankers and examiners with sufficient guideposts to effectively implement and oversee the significant changes that Basel II represents.

Background

The Federal Banking Agencies have provided for industry comment a detailed proposal that outlines guidance for banking organizations that are preparing to adopt the Basel II framework. The proposal indicates that under the IRB approach, banking organizations would use internal estimates of certain risk parameters as key inputs in the determination of their regulatory capital requirements. As the Agencies prepare a Notice of Proposed Rulemaking (NPR) later this year that will comprehensively implement the IRB approach and other elements of capital measurement and standards recently adopted by the Basel II Committee on Banking Supervision, the Proposal is intended to provide banking organizations with a description of the current views of the Agencies. The Proposal also provides an opportunity for comment on specific elements currently being developed including the components and characteristics of a qualifying IRB credit risk measurement, data maintenance, segmentation, and quantification framework for retail exposures.

CSBS Viewpoints Relating to the Proposal

CSBS, through a working group involving the state banking agencies that have chartered and regulate banking organizations that are either required to adopt Basel II or are planning to opt-in, has evaluated the Proposal and offers three primary views. Our comments reflect a regulatory perspective, with the expectation that much of the specific comments on issues such as estimated costs and burden associated with the proposed information collections will come from bank trade associations and bankers themselves.

Specific Requirements vs. Flexibility

The Proposal sets forth a four component structure of segmentation, quantification, data maintenance and oversight-control through a principles based approach that is consistent with supervisory safety and soundness concerns and existing bank retail credit risk management practice. It is apparent that the Agencies have endeavored to provide the right mix of specific mandatory requirements (to allow bankers to understand the Agencies' expectations) and a standards based approach that provides bankers with enough flexibility to tailor a program that works for their individual institutions. Attention to this important issue is reflected in the request for comment regarding whether any of the standards set forth in the Proposal should be mandatory minimum qualifying criteria and which should be for supervisory purposes only.

We note that the Proposal allows banks that manage their retail portfolios on the basis of average dollar loss rates and loss severity to indirectly estimate probability of default. This flexibility should encourage banks that are considering opting in.

CSBS also notes that the Agencies have endeavored to utilize straight forward, concise language throughout the Proposal to the extent that the complex subject matter allowed. CSBS commends the Agencies for their efforts in this regard, recognizing that improvements will follow the public comments received in response to the Proposal.

Prudential Safeguards

Appropriately, the Proposal requires banking organizations to document, verify and support their conclusions regarding the inputs used in determining regulatory capital for their retail credit exposures. In fact, prudential safeguards, such as an initial limit on the amount of capital banking organizations can reduce for mortgages, appear throughout the Proposal.

In the background section, banking organizations are advised that “nothing in this guidance should be interpreted as, weakening, modifying or superseding the safety and soundness principles articulated in the existing statutes.” Bankers are required throughout the Proposal to support their findings and approaches used to implement the draft guidance. They must validate, for example, that their retail IRB risk segmentation process separates exposures into segments with homogeneous risk characteristics that generate *reliable* long-run estimates of the IRB risk parameters. Similarly, bankers are required to develop statistical tests to “back-test” their IRB risk quantification processes.

The “Supervisory Expectations” section of the Proposal concisely outlines the types of actions that banking organizations are expected to take including the importance of sound segmentation, quantification, data maintenance and control and oversight mechanisms as fundamental elements of an effective program to define retail credit risk and determine minimum regulatory capital. Bankers are advised that the Agencies expect them to subject all elements of the risk segmentation system and quantification processes to thorough, independent and well documented validation. The Proposal also specified that bankers should utilize a variety of validation approaches. Additionally, the Agencies indicate that bankers must have a robust framework of control and oversight mechanisms to govern their entire IRB implementation. However, rather than providing proscriptive rules to define what that system should be, the Agencies, appropriately, identified the general principles and standards that would meet supervisory expectations.

While the principles based approach has merit, the Proposal also provides examples of approaches that the Agencies consider acceptable. Such examples (outlined in detail in Appendix A) are critical as bankers prepare for Basel II by investing heavily in management information systems to assist them with such tasks as segmenting their exposures into homogeneous pools based on risk characteristics, and maintaining the enormous amount of data that will be necessary to support their risk assessments. Based on feedback from banking organizations, the need for additional examples may become apparent.

Additionally, we commend the Agencies for providing a proper allowance for the role of expert judgment in the development and maintenance of bank retail credit risk management systems. We also value the clarity with which the Proposal reinforces the ongoing importance of examiner judgment in the assessment of the systems banking organizations will utilize.

Issues Outstanding

While the Proposal covers an impressive array of critical issues relating to the assessment of retail credit risk to determine appropriate level of regulatory capital, the Agencies acknowledge that additional matters require attention. Toward that end, CSBS is hopeful that the responses from banking organizations will enable the Agencies to draft a NPR that will provide more details on issues such as the definition of default and the definition of periods of high credit losses.

Conclusion

CSBS commends the Agencies for their efforts to set forth clear proposed supervisory guidance that illuminates their current thoughts relating to the IRB approach to determine regulatory capital for retail credit exposures. The Proposal provides specificity while attempting to incorporate sufficient flexibility for bankers. The Proposal also incorporates important prudential safeguards. The degree of burden the Proposal will impose will likely be the subject of many of the comment letters the Agencies receive. CSBS supports reducing the level of burden to the fullest extent possible while ensuring appropriate levels of safety and soundness are maintained.

More broadly, CSBS is hopeful that the implementation of the Basel II Accord will better align minimum capital levels with risk without facilitating a regulatory environment that drives industry consolidation as many community banks fear. Additionally, CSBS would support a transfer of key capital approaches for smaller non-Basel II banks that would produce more accurate (and perhaps lower) capital requirements if such approaches were based upon prudential safeguards and did not impose untenable burden for community banks.

Thank you again for the opportunity to comment. We stand ready to provide any additional information or respond to any questions that you may have.

Best personal regards,

A handwritten signature in black ink that reads "Neil Milner". The signature is written in a cursive, flowing style.

Neil Milner, CEO