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THE CLEARING HOUSE
Advancing Payment Solutions Worldwide

February 7, 2005

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the
Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Attention: Docket No. OP-1215

Robert E. Feldman, Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Attention: Comments/Legal ESS

Office of the Comptroller of the Currency
250 E Street, SW
Public Reference Room
Mail Stop 1-5
Washington, DC 20219

Attention: Docket No. [04-22]

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552

Attention: No. 2004-48

Re: Internal Ratings-Based Systems for Retail Credit Risk for Regulatory Capital

Ladies and Gentlemen:

The Clearing House Association L.L.C. ("The Clearing House"), an association of major commercial banks,[1] appreciates the opportunity to comment on the proposed guidance for internal ratings-based systems for retail credit risk for regulatory capital (the "Proposed Guidance") recently published by the Board of Governors of the Federal Reserve System (the "Board"), the Federal Deposit Insurance Corporation (the "FDIC"), the Office of the Comptroller

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1 The members of The Clearing House are: Bank of America, National Association; The Bank of New York; Citibank, N.A.; Deutsche Bank Trust Company Americas; HSBC Bank USA, National Association; JPMorgan Chase Bank, National Association; LaSalle Bank National Association; U.S. Bank National Association; Wachovia Bank, National Association and Wells Fargo Bank, National Association.

of the Currency (the "OCC") and the Office of Thrift Supervision (the "OTS") (together, the "Agencies"). We commend the Agencies' efforts toward implementation of the internal ratings-based ("IRB") approach to computing regulatory capital for retail credit exposures in accordance with the *International Convergence of Capital Measurement and Capital Standards: A Revised Framework* ("Basel II"). We hope that our comments on the Proposed Guidance contribute meaningfully to the consultative dialogue that the Agencies have maintained with the banking industry throughout this process.

Our comments on the Proposed Guidance are set forth below. In addition, several of our member banks have submitted individual comment letters to the Agencies. Our comments below outline common concerns and suggestions of the member banks of The Clearing House.

A. *Prescriptive Nature of the Proposed Guidance*

We appreciate that the Agencies have taken a principles-based approach to the Proposed Guidance. A principles-based approach, as opposed to a set of rigid and complicated rules, will foster innovation in the development of best risk management practices, and will provide banks with the flexibility to implement the finalized guidance efficiently and in accordance with their internal models and procedures. The Proposed Guidance provides supervisory standards for banks to implement when establishing an IRB system for retail credit risk, and indicates that the supervisory standards were drafted as general principles because they are meant to be flexible in nature. We believe, however, that the detailed and prescriptive text following each supervisory standard would limit a bank's ability to develop and improve its risk management framework. Much of the text following the supervisory standards establishes strict requirements contrary to the spirit of the standards themselves. As examples, and as discussed further below, the inclusion of non-accrual status in the definition of default is inconsistent with current industry practice and regulatory guidance, and the requirement that risk parameter estimates be updated quarterly is inconsistent with Basel II and would not likely improve the quantification process.

We believe that the Proposed Guidance would be most effective in its final form if it provided a guide to appropriate practices instead of a set of specific requirements. We, therefore, suggest that the focus of the finalized guidance remain on each supervisory standard. We believe that the supporting text should merely illustrate and expand upon the guidance set out in each supervisory standard.

B. *Definition of Default*

The Proposed Guidance requires that banks use the IRB definition of default for purposes of estimating their IRB retail risk parameters.[2] The IRB definition of default provides that a retail exposure is in default when any one of the following loss recognition events occurs: (1) loss recognition as defined in the Federal Financial Institutions Examination Council Uniform Retail Credit Classification and Account Management Policy; (2) assignment of the exposure to non-accrual status or (3) a charge-off is taken against the exposure. Banks currently utilize their own definitions of default in risk management and economic capital models. Implementation of a new, uniform definition of default as required by the Proposed Guidance would require each bank to modify its existing models at great cost and effort, with little (if any) realized effect, as the modifications would have little impact on the accuracy of capital calculations. We believe that for this reason, a uniform definition of default is overly burdensome and unnecessary, as well as being inconsistent with a principles-based approach.

The Agencies have specifically requested comment on whether the non-accrual status of an exposure should be included in the IRB definition of default.[3] If an IRB definition of default were to be implemented, we do not believe that non-accrual status should be included in this definition. As the Agencies noted in the Proposed Guidance,[4] there is neither a GAAP nor a

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2 Internal Ratings-Based Systems for Retail Credit Risk for Regulatory Capital, 69 Fed. Reg. 62,748, 62,759 (Oct. 27, 2004).

3 *Id.* at 62,750.

4 *Id.*

regulatory reporting requirement to place retail exposures on non-accrual status, and, as a result, industry practice in this regard varies widely. Each bank has its own set of non-accrual rules, which vary in scope and application to different loan types.

C. *Treatment of Defaulted Accounts*

To calculate capital required for defaulted accounts, the Proposed Guidance requires that banks establish their best estimates for the losses incurred on these accounts, which depend largely on current conditions. To establish such estimates, banks must segment defaulted accounts separately from non-defaulted accounts. Banks must then estimate values for two additional risk parameters: best estimate of expected loss ("BEEL") and potential loss given default ("PLGD"). The difference between these two values will be the amount of capital required for defaulted accounts.

We agree that capital should be assigned to defaulted accounts to protect against uncertainty of recovery. However, by requiring that defaulted accounts be segmented separately and subjected to the estimation of two additional and unfamiliar risk parameters, the Proposed Guidance requires additional and complicated computational requirements that may not be necessary. Because BEEL and PLGD are not familiar to the industry, the additional computations necessary to calculate these risk parameters would be unduly burdensome in practice. We believe that a simpler and more uniformly accurate approach would eliminate the proposed segmentation of defaulted accounts, as well as computation of BEEL and PLGD estimates. Instead, this approach would implement a calculation of conservative loss given default ("LGD") estimates for non-defaulted accounts, which would build in potential loss resulting from defaulted accounts, and be reflected in resulting capital amounts.

D. *Treatment of Unseasoned Accounts*

The Proposed Guidance requires that seasoning be considered in determination of probability of default ("PD") estimates. According to the Proposed Guidance, a segment that contains unseasoned loans should be assigned a greater PD estimate that reflects the annualized cumulative default rate over the segment's life. A segment that contains seasoned loans should be assigned the long-run average of one-year PDs. We believe that this special arrangement for unseasoned loans should be eliminated for two reasons. First, it would result in an overstated capital requirement. Because capital is calculated using a PD over the life of the exposure, the exposure is assigned capital in a given period for risk that exists outside of that period. The result is that the risk for such unseasoned exposures is likely to be overstated, resulting in an overstatement of capital requirements. Second, the Basel II framework is based on one-year PD estimates. The recommendations outlined in the Proposed Guidance with respect to seasoning create an inconsistency with the remainder of the Basel II framework, which is likely to cause confusion and increased cost of implementation.

E. *Loss Given Default Estimation*

The Proposed Guidance provides that LGD estimates must reflect the concept of economic loss, which incorporates the loss of value of a defaulted loan and collateral plus the costs of workouts and collections, net of any recoveries. The Proposed Guidance provides that all losses, costs and recoveries should be discounted to the time of default. We believe that this discounting recommendation should be eliminated because it would impose significant computational burdens and implementation costs, and the impact on resulting capital would be insignificant for the many retail exposures that have a short recovery horizon. As an alternative to discounting all retail exposures back to the time of default, we propose that this type of discounting be conducted (if at all) only with respect to long recovery horizon assets such as mortgages, because accounting for the time value of money with respect to these assets may have a material effect on resulting capital requirements.

F. *Quarterly Updates of Risk Parameter Estimates*

We understand the importance of updating risk parameter estimates to reflect current data and new techniques used to analyze such data. Basel II recommends that risk parameter estimates be updated at least on an annual basis, and most banks currently comply with this recommendation. The Proposed Guidance, however, requires that risk parameter estimates be updated at least on a quarterly basis.

There are two reasons why we do not believe that banks should be required to update risk parameter estimates on a quarterly basis. First, it is unlikely that the quantification process would benefit from quarterly updates to risk parameter estimates. The purpose of quantification is to predict long run probabilities of default as well as LGD and exposure at default ("EAD") at stressed levels. Quarterly updates to risk parameter estimates would not result in a material improvement in the accuracy of such estimates. Second, quarterly updates could actually reduce accuracy. The process of determining risk parameter estimates is not automated. The process requires careful consideration and judgment on the part of an analyst following labor intensive data analysis. If quarterly updates are required, time may not permit such careful consideration. The process of determining updated estimates would likely become a mechanical process, and the accuracy of the estimates may be adversely affected.

G. *Proposed Floors in PD and LGD Estimation*

We believe that the proposed floors in PD and LGD estimates should be eliminated. Mandatory floors in PD and LGD estimates undermine the ability of banks to analyze data sets and use data driven calculations to determine the most accurate PD and LGD estimates for each segment. If the data indicate that a particular segment results in an estimate that is below a prescribed floor and the estimate is supported by historical performance of the segment, we see no reason why the estimate should be artificially raised to a floor level. Moreover, prescribed floors are inconsistent with a principles-based approach.

H. Flexibility in Computing Economic Capital

The language of several paragraphs in the Proposed Guidance seems to suggest that retail IRB risk parameter estimates must be used to determine both regulatory capital and internal economic capital. For example, the guidance following RS-55 provides that "IRB risk parameter estimates of PD, LGD, and EAD should be incorporated in credit risk management, internal capital allocation, and corporate governance."[5] We assume that the intended effect of this language was not to prescribe methodology for determining internal economic capital, because to do so would be contrary to the stated intent of the Agencies and the spirit of Basel II. It is our clear understanding that both Basel II and the Proposed Guidance aim in part to streamline and conform the methods used by banks to calculate regulatory capital. Although a bank's methodology for determining regulatory capital may at times align with its methodology for determining internal economic capital, there is no requirement that the methodologies coincide at all times. Banks require flexibility in deciding which procedures to utilize in order to compute internal economic capital.

We suggest that where language in the Proposed Guidance may be construed to require identical risk parameter estimates for purposes of computing regulatory capital and internal economic capital, this language be modified to clarify that the IRB risk parameter estimates only must be used for determining regulatory capital, and may be used to determine internal economic capital.

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5 *Id.* at 62,770.

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The Clearing House appreciates the opportunity to comment on the Proposed Guidance. If the Agencies would like additional information regarding these comments, please contact Norman R. Nelson, General Counsel of The Clearing House, at (212) 612-9205.

Sincerely,