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1801 Market Street, Suite 300, Philadelphia, PA 19103

MAURICE H. HARTIGAN II  
President & CEO

215-446-4001 • Fax 215-446-4008

E-mail:  
[mhartigan@rmahq.org](mailto:mhartigan@rmahq.org)

May 29, 2007

Office of the Comptroller of the Currency  
250 E. Street, S.W. Mail Stop 1--5  
Washington D.C. 20219

Jennifer J. Johnson, Secretary  
Board of Governors of the Federal Reserve System  
20<sup>th</sup> Street and Constitution Avenue, NW  
Washington D.C. 20551

Robert E. Feldman, Executive Secretary  
Attention: Comments RIN 3064 - AC73  
Federal Deposit Insurance Corporation  
550 17<sup>th</sup> Street, NW  
Washington D.C. 20429

Regulation Comments  
Chief Counsel's Office  
Office of Thrift Supervision  
1700 G. Street, N.W.  
Washington D.C. 20552  
Attention: No. 2007 – 06

**RE: RMA Response to the Proposed Supervisory Guidance for Internal Ratings-Based Systems for Credit Risk, and the Supervisory Review Process (Pillar 2) Related to Basel II Implementation: OCC Docket Number 2007-004, FRB Docket Number OP-1277, FDIC Re: Basel II Supervisory Guidance, OTS No. 2007-06**

Ladies and Gentlemen:

The Risk Management Association (RMA)<sup>1</sup> is pleased to comment on the Proposed Supervisory Guidance for Internal Ratings-Based Systems for Credit Risk, and the Supervisory Review Process (Pillar 2) Related to Basel II Implementation.

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<sup>1</sup> Founded in 1914, RMA is a not-for-profit, member-driven professional association whose sole purpose is to advance the use of sound risk practices in the financial services industry. RMA promotes an enterprise approach to risk management that focuses on credit risk, market risk, and operational risk. RMA's membership consists of more than 3,000 financial services providers and 18,000 risk management professionals who are chapter members in financial centers throughout North America, Europe, and Asia/Pacific.

Comptroller of the Currency  
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Federal Reserve Board  
Federal Deposit Insurance Corporation  
Office of Thrift Supervision  
May 29, 2007

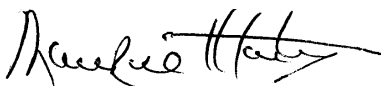
As the Agencies are aware, RMA has been actively involved in the effort to reform the regulatory capital guidelines for the past decade and fully supports a more risk-sensitive regulatory capital standard. As we noted in our response to the NPR, however, RMA has become increasingly concerned about the prescriptiveness of the Basel II implementation process in the U.S. We fear that it could have a chilling effect on continued industry innovation in risk management procedures. We also continue to be greatly concerned over the continued divergence from the Basel II Framework adopted in June 2004.

RMA believes that the only way to move forward at this late point in time requires the full adoption of the 2004 Framework – that is, allowing the full availability to all U.S. institutions of the options the Framework provides (Standardized, Foundation IRB, and Advanced IRB).

Continued U.S. divergence from many of the fundamental principles of the 2004 Framework at this late stage in the Basel II implementation is problematic for many reasons. The addition of the 10 percent aggregate floor, three-year phase in period, and the modified definition of default for wholesale exposures remain our most pressing concerns. Additional significant concerns include the U.S. addition of the ELGD versus LGD concept, and the use of the Supervisory Mapping Function, and the different treatment of some equity investments. RMA is also concerned that the U.S. has eliminated the 2004 Framework's treatment of loans to small-to-medium business enterprises (SME).

It is our hope that the Agencies will find RMA's input useful and we stand ready to be of any further assistance that you may deem appropriate. Please feel free to contact me at 215-446-4001 or via email at [mhartigan@rmahq.org](mailto:mhartigan@rmahq.org), or Pam Martin, our Director of Regulatory Relations, at 215-446-4092 or via e-mail at [pmartin@rmahq.org](mailto:pmartin@rmahq.org)

Sincerely yours,



Attachment

**Comment on the Supervisory Guidance  
For U.S. Basel II Implementation**

**The Risk Management Association  
Capital Working Group**

**May 29, 2007**

## I. Introduction and Overview

The RMA Capital Working Group (“CWG”)<sup>2</sup> appreciates this opportunity to comment on the Proposed Supervisory Guidance for Internal Ratings-Based Systems for Credit Risk, Advanced Measurement Approaches for Operational Risk, and the Supervisory Review Process (Pillar 2) Related to Basel II Implementation (“Guidance”) published in the Federal Register on February 28, 2007. The CWG remains a staunch supporter of the process of modernizing the Pillar 1 minimum regulatory capital requirements to make them truly sensitive to the risks of each bank’s portfolio of activities. Further, we have welcomed the U.S. banking agencies’ dialogues with industry experts on a wide range of matters pertaining to the development and implementation of the new Basel II capital standards in the U.S.

We continue to believe that the Advanced Internal Ratings Based (AIRB) capital process for mandatory and opt-in institutions can evolve into an appropriate set of capital requirements that truly reflects the risk of the institution willing to engage in the very complex and costly process of Basel II implementation. For some institutions the resulting capital requirements will be lower than under the old Accord; for others, the opposite may be the case.

We also appreciate agency efforts to limit the prescriptiveness of the Guidance in order to accommodate a wide range of acceptable practice and to minimize compliance costs – although in some areas, we have further suggestions for moving toward greater principles-based guidance. We recognize that there is a fine-line to be drawn between, on the one hand, allowing Basel II banks to use existing cost-effective and sound-practice techniques for, say, estimating risk parameters, versus, on the other hand, providing regulators with assurance that internal Basel II procedures are not being conducted in a manner that is aimed simply at minimizing the resulting capital requirement. As a Group, we are firm believers in “getting it right” from the perspective of risk measurement and risk management. This confidence in best-practice risk measurement is at the heart of the Basel II process, and we appreciate the agencies’ attempts to avoid mandating processes that would choke off innovation in the field of risk measurement. Innovation is necessarily associated with a wide range of acceptable practice. As innovations become standard practice, some practices drop off the list of “acceptable” practices, while others are added. This evergreen nature of risk measurement also means that the Basel II regulatory structure itself is an evergreen process.

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<sup>2</sup> The Risk Management Association (RMA) is the leading professional association dedicated to the measurement and management of risk in banking and finance. The RMA Capital Working Group consists of senior officers at the leading banking institutions in the U.S. and Canada who are responsible for the measurement of risk and the determination of economic capital. Individual banks that are members of the Capital Working Group may have views that differ from those expressed in this paper and may be responding separately to the Guidance. The names of the institutions and staff members contributing to this paper are provided in an Appendix.

In the very broadest terms, our concerns over the proposed Guidance package – in addition to the general concern regarding prescriptiveness expressed above -- can be grouped into 3 areas:

- Timing. After our extensive review of the Notice of Proposed Rulemaking (“NPR”) and then the Guidance, we remain apprehensive about the ability of the U.S. regulators to incorporate observers’ major criticisms of the NPR and Guidance within a final rule and final Guidance in a timely fashion. As U.S. regulators are well aware, major multi-national banks, as well as smaller institutions, in the G-10 countries already have started their “parallel run” period, because the other Basel II countries have moved forward to embrace the 2004 mid-year Framework published by the Basel Committee. The delay in the U.S., while flowing from a series of legitimate concerns, places all U.S. banks of all sizes at a competitive disadvantage to their non-U.S. competitors and to non-regulated U.S. entities. This delay, to a significant extent, may arise from the multiplicity of banking regulators in this country – and so we urge the various U.S. agencies to resolve their differences through meaningful compromise as soon as possible.
- Issues of competitive equity. As detailed in our response to the NPR, there are very significant differences between the U.S. version of Basel II (as expressed in the NPR) and the Framework being used by the other countries. These differences, if accepted within the U.S. regulation, will clearly lead to competitive inequities between the U.S. multinationals and their large non-U.S. counterparts. Moreover, even smaller U.S. banks will be competitively handicapped by the differences between the U.S. version and the Framework. We have discussed extensively these competitive issues facing U.S. banks of all sizes in our response to the NPR.<sup>3</sup> Among our concerns:
  1. Denying U.S. banks of all sizes the ability to choose among the 3 Basel II Pillar 1 capital frameworks – Standardized, Foundation, and Advanced. This is simply a matter of consistency, fairness, and facilitating home-host coordination on cross-border issues.
  2. The aggregate 10% floor on capital reductions applicable to the U.S. version of Basel II. This floor will serve to move mandatory and opt-in banks away from low-risk activities during the various stages of the phase-in period, and, in the end, may lead to permanently higher capital requirements, for a given amount of risk, for U.S. banks of all sizes.
  3. A longer phase-in period involving higher capital floors during each phase-in period than for non-U.S. banks.

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<sup>3</sup> See RMA “Response to the U.S. Notice of Proposed Rulemaking Regarding the Basel II Capital Regulations,” March 26, 2007, especially pp. 2-8.

4. In the U.S. version, elimination of the lower asset-value-correlation levels for loans to Small-and-Medium-Sized Enterprises (“SME”). The treatment in the Framework is appropriate, given widespread acceptance of lower AVCs for smaller enterprises, whose defaults are more idiosyncratic in nature.

In addition, there are significant differences between the Framework and the U.S. NPR that affect primarily the competitive position of the multi-national U.S.-head-quartered banks vis a vis their international peers and their non-bank competition, and, as well, raise the compliance costs for U.S. multinationals. We treat some of these differences in Section II below.

- Instances of unintended prudential consequences within the NPR and the accompanying Guidance. We will be discussing several instances of such unintended consequences in the sections below. Chief among these are cases in which the agencies impose too-high capital requirements for low risk assets -- presumably because regulators want effective “minimums.” However, the floors simply serve to drive banks into higher risk lending for which regulatory capital requirements are *not* above market-determined levels of capital. Cases include the floor of 10% on LGDs for mortgage assets (driving banks away from low LTV mortgages), or the Supervisory Mapping Function for downturn LGD which drives banks away from loans of any type with very low expected LGDs of only a few percentage points. In another example of unintended consequences, the treatment of tranching guarantees of retail pools, coupled with the high compliance costs of implementing such treatment, serves to dissuade banks from using such a risk-mitigation technique.

Note that, because of the delay in publishing the Guidance (which appeared in the Federal Register only one month before the end of the comment period for the NPR), our Group has only now been able to fairly completely assess the NPR in the context of the specifics of how the NPR would be implemented. Even now, however, not all elements of the NPR-Guidance complex have been fully digested by the various Basel II implementation groups within each of our member institutions. Therefore, we can expect to have individual institutions, or the CWG as a whole, raise further issues as they arise.

In this response, we begin with a discussion of our highest concerns regarding the combination of the Guidance and the NPR. In some cases, the concern pertains only to the language in the Guidance; in other cases, language in both the NPR and Guidance is at issue. Later sections deal with each of the chapters in the Guidance. However, the CWG is not now responding, in specific detail, to issues raised within Chapter 5 (Data Management and Maintenance); Chapter 9 (Counterparty Credit Risk Exposure), which we expect to be addressed by ISDA; and Chapter 11 (Securitization), other than some broad issues. Further, response to the Operational Risk portion of the Guidance will be handled by the RMA’s Advanced Measurement Approaches Group (“AMAG”) and/or by individual institutional members.

## II. Highest Concerns.

### A. The wholesale definition of default.

The major problem with the U.S. definition is the portion that requires an AIRB bank to treat as a default any sale of an asset or group of assets at a credit-related loss of 5% or more. This requirement does not exist in the Framework. Further, it is at odds with the general requirement that banks must appropriately down-grade loans to obligors that have suffered a decline in their credit status. Such a credit-related decline in grade may leave an obligor far short of “default” status, yet, if the bank sold the loan, a 5% or more discount from current carrying value could easily apply. Further, sales at a discount may be due to other reasons – such as differences between the portfolio composition of the buyer and the seller – which are difficult to distinguish from credit-related price declines.

The definition of default within the NPR is reinforced within the Guidance. S2-9 indicates that the bank must have a separate wholesale grade termed “default”, while S2-1 indicates that the occurrence of default on one of the bank’s facilities to a single obligor generates a default on all such facilities. Thus, if the bank sells a portion of its holding of loans to a single obligor at a credit-related loss of 5%, then all of its other exposures to that obligor must be placed in the “default” grade – even though the economics of the situation might argue for, at most, a one or two click downgrade in the status of the remaining exposures. Clearly, the NPR/Guidance treatment of the definition of default has the unintended consequence of dissuading banks from using loan sales to help manage the risk of their commercial loan portfolios.

Additionally, the mere existence of the difference in default definitions between the U.S. version and the Framework serves to significantly increase the cost of compliance for U.S. banks with multi-national operations. For example, the difference in default definitions coupled with the requirement of a specific default grade, means that a single obligor will have different ratings in home and host jurisdictions when no such rating difference is implied by the underlying economics.

The most straightforward solution to both the unintended consequence of the U.S. definition as well as its added compliance costs for U.S. multi-nationals is to harmonize the U.S. definition with that of the Framework by eliminating the “sale at a credit-related loss” provision.

Removal of the sale-at-a-loss provision would still leave one remaining significant difference between the U.S. version and the Framework version of the default definition – the U.S. version uses non-accrual status as one of the triggers for default definition, while the Framework uses 90-days-past-due. Some U.S. banks had asked for the non-accrual treatment, while the multi-national U.S. banks more generally are concerned about the compliance costs associated with this definitional difference. At a minimum, U.S. regulators should allow the U.S. multi-nationals to choose between the non-accrual

versus 90DPD versions. The ultimate effect on PD estimation is likely to be very minor, but compliance cost savings would be substantial.<sup>4</sup>

B. S2-1: The occurrence of default on one of the obligor’s facilities held by the bank generates a default for all such facilities.

Closely related to the definition of default issue, is the Guidance’s treatment of multiple facilities to a single obligor. In general, for most uncollateralized commercial loans, S2-1 would be consistent with banks’ internal risk management practices. However, for collateralized loans in which the underlying collateral generates the revenues expected to service the debt (e.g., certain commercial real estate loans, especially multi-family lending), the default probability of the loan depends on the details of the underlying revenue-producing collateral. In particular, the bank would typically take into account debt-service coverage ratios associated with the income-producing collateral, along with loan-to-value ratios or other aspects of the collateral, when originating such facilities. Default can be expected when the revenues from the property are insufficient to service debt, and/or the market value of the property declines below the loan amount. Further, there are usually specific provisions within such facilities that preclude cross-default treatment. Additionally, so-called “single-action” state laws require the bank, in the event of default, to go after either the obligor or the collateral, but not both. Cost and timing considerations generally result in the bank going after the property in the event of default.

The practical consequence of these state laws and contractual facility language – as well as the underlying economics of the loan – cause best-practice banks to assign separate PDs to separate income-producing real estate facilities, *for internal risk measurement purposes*, even if the legal obligor associated with several facilities is the same partnership or special-purpose vehicle. We believe that the NPR and the Guidance should reflect this reality, by crafting what amounts to an exception to S2-1 based on the type of IPRE loan or the existence of anti-cross-default provisions or relevant single-action state laws.

C. ELGD, LGD, and the Supervisory Mapping Function.

We have discussed at length in our response to the NPR the compliance burden issues and competitive inequity issues associated with the U.S. introduction of the ELGD-LGD distinction and the use of the Supervisory Mapping Function (“SMF”).<sup>5</sup> At a minimum, the U.S. treatment causes Risk-Weighted-Asset comparisons between large U.S. banks and their non-U.S. competitors to be meaningless. Moreover, compliance burden is greatly increased for U.S. AIRB banks, even though, other things equal (for a given

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<sup>4</sup> We applaud the language of the Guidance in paragraph 15 of Chapter 2 regarding the forgiveness of minor amounts, such as fees, for relationship purposes unrelated to possible financial distress of the obligor. This provision substantially reduces compliance burden associated with applying the default definition.

<sup>5</sup> See the RMA response at pp. 6-7.



ELGD and LGD), the *effective* Total Capital requirement is only slightly increased by the U.S. treatment.

But other things are not equal. First, the SMF acts to arbitrarily increase the downturn LGD by a very high percentage amount in the case in which a) the bank is required to use the SMF, and b) the properly estimated ELGD is low. For example, if ELGD is 10%, the SMF generates an LGD of 17.2% -- a 72% increase that translates directly into a 72% increase in capital.<sup>6</sup>

Second, paragraph 113 (Chapter 4) of the Guidance indicates that:

“If a bank obtains supervisory approval to use its own estimates of LGD for an exposure subcategory, it must use internal estimates of LGD for all exposures within that subcategory. Within retail, the three subcategories are residential mortgage, QRE, and other retail, while within wholesale credit the two subcategories are high-volatility commercial real estate (“HVCRE”) and all other wholesale.”

This “all or nothing” approach to use of the SMF effectively throws out important internal or external data that could produce best-practice estimates of downturn LGD – in any case where the bank does not possess appropriate downturn LGD data for each of its products or segments within a loan category. Paragraph 113, therefore, runs counter to the intent and spirit of Basel II, producing a disincentive to acquire data on downturn LGDs unless such data can somehow be acquired for all of the sub-category.

We believe that the ELGD-LGD distinction, as well as the accompanying SMF structure, should be eliminated from the U.S. rule – both because of the inappropriately conservative nature of the SMF and because of the very substantial added compliance costs. Absent this treatment, we highly recommend that paragraph 113 be eliminated, allowing U.S. supervisors to approve internal estimates of downturn LGD on a product level or segment level basis as appropriate.

#### D. EADs.

Paragraph 141, Chapter 4, of the Guidance states that

“To derive EAD estimates for lines of credit and loan commitments, characteristics of the reference data are related to additional drawings on an exposure up to and after the time a

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<sup>6</sup> The difference between the U.S. version and the Framework is heightened by the need for the U.S. bank to include a downturn period in the estimate of ELGD. Thus, if the U.S. bank doesn't have internal data on downturn LGDs it must either acquire external data or make a conservative upward adjustment of the internal data to reflect the downturn period -- just to estimate *ELGD* (since ELGD must be estimated to include a downturn period). Then, if the supervisor does not approve the bank's downturn LGD estimate, the U.S. bank must make a further upward adjustment to its downturn LGD estimate via use of the SMF. This process seems contrived to produce excessively high LGD estimates that would be at odds with practice in the other Basel countries, and that might very well produce uneconomically high capital estimates.

default event is triggered. Estimates of any additional extensions of credit expected by a bank subsequent to realization of a default event should be factored into the quantification of EAD. The estimation process should be capable of producing a plausible average estimate of draws on unused available credit (e.g., LEQ) to support the EAD calculation for each exposure or retail segment.”

Typically, the accounting and economics of post-default extensions to the obligor point toward treatment of such extensions as an increase in cost of recovery (affecting LGD), not an extension of credit (affecting EAD). Such extensions would generally take place within the context of a wholesale exposure. For example, the bank might make an extension to the defaulted obligor to finish a building project. This extension would not be made unless the bank concluded that recoveries, net of the added expense associated with the extension, are significantly improved by finishing the construction.

Also, such extensions may not be literally “extensions of credit,” but rather may be accounted for as a recovery-related expense. Thus, even if the loan was structured as a line of credit, default might trigger the suspension of the line, but recovery management might call for a cash payment to the builder.

We believe that the Guidance should mirror the industry’s treatment of post-default cash extensions as amounts that should affect measured LGD, rather than measured EAD. Since EAD and LGD both enter the Basel II credit risk model in linear fashion, there should be a neutral result on calculated regulatory capital, but a significant cost-of-compliance saving for the AIRB bank.<sup>7</sup>

#### E. Treatment of Guarantees.

1. Supervisory standard S4-3 requires that the bank calculate the PD of the obligor prior to calculating the PD of the guarantor. This two-step procedure is not required for retail guarantees (Chapter 4, paragraph 20).

We view the two-step process for wholesale guarantees as burdensome and not meaningful from the point of view of risk measurement and management. The grading of the obligor contains no useful information in circumstances where the guarantor acts to guarantee several facilities of multiple obligors (such as might be the case for a parent and several subsidiaries). Similarly, when the loan contract calls for the guarantor to make good on scheduled loan payments, there is no “default” condition that attaches to the actual obligor, but rather to the guarantor. Such contracts occur, for example, when

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<sup>7</sup> While we have focused on the cases of construction or project lending, still another case deserves equal attention. In some segments, the default definition may trigger a default which is followed quickly by a complete cure (including the payment of foregone interest and fees since the time of default). A literal application of the Guidance language could erroneously result in extensions of credit after the cure being treated as increasing the estimate of the segment’s EAD. In fact, the return-to-current status after default results in an observation of a zero LGD, which should affect the bank’s LGD estimate, not its EAD estimate.

the lead partner of a small or middle-market business guarantees the business loan. In such cases, typically banks would not seek such a guarantee unless the rating grade of the guarantor was higher than that of the obligor. A very cursory review of the obligor and guarantor can suffice to make such a determination. If it turns out that the reverse is true – the credit quality of the obligor is higher than that of the guarantor – then the bank will have estimated a conservative PD for use in the Basel II credit risk function.

It seems as though S4-3 is intended to give the supervisor some overall sense of the credit-enhancing effect of guarantees, measured in terms of the impact of the guarantee on regulatory capital. This presumed supervisory need is reflected in the proposed Call Report sections that require AIRB banks to report the “before” and “after-guarantee” PDs. However, we believe that, other than for some arcane academic interest, the PD of the obligor (in the context of a PD-substitution treatment), is either not useful or misleading. A wide (narrow) gap between the obligor PD and the guarantor PD is not indicative of shortcomings (strengths) in the bank’s PD measurement system, its success (failure) in risk management and mitigation policies, or its particular type of lending business. Such data should not be collected by regulators<sup>8</sup> and, most importantly, the bank should not be burdened with estimating the obligor PD at the point of origination or over time. This burden is especially critical in the context of small business and middle-market lending, in which the seeking of guarantors is common practice.

## 2. Implied Support.

The Guidance (S2-11 and following paragraphs) establishes 10 requirements, all of which must be met, to take implied support into consideration when grading a loan. This is much too prescriptive and at odds with best grading practices. Rather, the 10 points might be considered among the factors when deciding on the existence and extent of implied support. For example, rating agencies now consider implied support to be attributable to non-investment grade supporters. Also, for implied support from a private company, the internal grade of the supporter might be considered, instead of only considering support from investment-grade publicly-rated supporters. We recommend that the Guidance language be changed to eliminate the 10 conditions or at least treat them as factors for consideration in the bank’s treatment of implied support.

## 3. Tranched guarantees for pools of retail credits.

Chapter 11 (S11-1) indicates that

“Banks must use the securitization framework for any exposures that involve the tranching of credit risk (with the exception of a tranched guarantee that applies only to an individual retail exposure).”

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<sup>8</sup> Perhaps the Call Report data collection exercise can be restricted to qualifying credit derivatives.

We cannot find a rationale for this treatment in which securitization or synthetic securitization is the required treatment for any guarantee that is not clearly otherwise defined within the NPR's sections on guarantees. This requirement results both in uneconomically high regulatory capital requirements and in significant compliance costs – a double burden for both the “guarantor” and the bank receiving the guarantee.

Consider, as an example, the case in which Bank A sells a pool of retail credits to Bank B, while providing Bank B with a guarantee to cover the first \$X of losses on the pool. Because the guarantee is not one in which loss coverage is pro rata on each individual asset or a percentage of all pool losses (but rather covers only the first dollars of pool loss up to a given amount), synthetic securitization treatment appears to be required under S4-5 (and this particular case appears at the end of Example 5 in Appendix B to Chapter 4).

In this example, Bank A, the “guarantor” under S4-5, would not have a position that clearly involves a gain-on-sale or CEIO position, or a rated position, or a position subject to IAA -- rather Bank A would have to use the Supervisory Formula. Under the SF, Bank A has a first-dollar position subject to a dollar-for-dollar capital deduction (50% each from Tier 1 and Tier 2 capital) up to a cap of  $K_{IRB}$ .

The compliance costs for the recipient of the guarantee – Bank B – may be higher than for Bank A. It too must use the SF in determining its capital requirement for the pool. However, Bank B's position would be construed as being a combination of all the mezzanine and senior positions after the first-dollar position of the guarantor. Therefore, Bank B does not have quite so simple a calculation procedure as Bank A. In some cases, depending on the nature of the underlying assets and the amount of the fixed dollar guarantee, Bank B could receive some reduction in its capital requirement relative to not having the benefit of the guarantee – in other cases there might be little or no such benefit. But any capital benefit would only arise after incurring the significant compliance costs associated with the SF.

At a minimum, the compliance costs for both Bank A and Bank B in our example could be substantially lessened by giving each bank the option of calculating the regulatory capital requirement as if the bank held all of the pool on its balance sheet and the guarantee did not exist.<sup>9</sup> **Please refer to our further discussion of guarantees subject to securitization treatment under Chapter 11 (Securitization).**

#### F. Treatment of equity positions.

1. Neither the Guidance nor the NPR mentions the possible grandfathering of equity investments. The Accord permits national supervisors to grandfather certain

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<sup>9</sup> Bank B's position potentially also be handled by calculating its total loss in the tail event ( $K_{IRB}$  defined as UL, because it will be holding a reserve against the pool), then subtracting the dollar amount of the guarantee. To this simple calculation could be added a capital charge for counter-party credit risk that would depend on the credit rating of the guarantor.

exposures for up to 10 years.<sup>10</sup> We suggest that the agencies consider a simple rule that currently grandfathered equity exposures, and all existing equity exposures that currently are not covered by the U.S. non-financial equity rules but fall under the expanded Basel II definition, would continue to receive 100% risk weight treatment (and not be counted toward the 10% of regulatory capital threshold) until the exposures leave the balance sheet.

2. The NPR rule defines an investment fund exposure, to be subject to one of the look-through methods, as one in which the fund has no material liabilities. We are concerned that the agencies are considering applying securitization treatment to investment funds *with* material liabilities and we would object to such a treatment. This would effectively require capital deduction for investments in hedge funds – a very severe treatment in relation to a 400% risk-weight for a private equity investment in a non-publicly traded company under the SRWA. **Please refer to our further discussion of “hedge funds” under Chapter 11 (Securitization).**

3. As noted in our NPR response, the inability to use the IMA only for certain portions of the equity portfolio (the “all or nothing” approach) acts as a disincentive for the bank to implement the IMA. S10-1 effectively requires that “a bank may apply (i) the SRWA to private equity exposures and the IMA to public equities, or (ii) the IMA to all equity exposures, or (iii) the SRWA to all equity exposures.” However, so long as the Pillar 2 process detects no attempt at “cherry-picking” via selective use of IMA, the bank should be permitted to use the Internal Models Approach (or, conversely, the SRWA) for any portion of its equity portfolio. While it is true that IMA is more readily implemented in the case of publicly traded equities, private equities have measurable attributes that can serve as proxies for observed trading prices. Conversely, certain types of publicly traded equities (e.g., those traded on non-U.S. exchanges) may not lend themselves to a validated IMA. Finally, note that the Guidance apparently does not permit the IMA to be used for investment fund positions under the look-through approaches. We believe the SRWA or IMA choice should apply to the look-through approaches as well (depending on the status of model development and data availability).

#### G. Corporate Governance of Advanced Systems.

The Guidance places great emphasis on Board of Directors approval of key portions of the advanced systems. See Attachment 1 below for a complete list of these Board requirements in various sections of the Guidance. Regulatory staff has indicated that these governance requirements do *not* mean that Boards need outside consultants or increased internal audit staff to help them make such determinations. Language to this

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<sup>10</sup> Paragraph 267: “For a maximum of ten years, supervisors may exempt from the IRB treatment particular equity investments held at the time of the publication of this Framework.”

point in the Guidance would be helpful, especially given the specific nature of the requirements for Board approval.<sup>11</sup>

Additionally, the Guidance appears to present especially difficult problems associated with Board governance of the advanced systems of subsidiary banks in a multi-bank bank holding company environment:

“...each entity’s board and senior management ensure that such processes are appropriately modified from the consolidated ICAAP to address the unique structural and operating characteristics and risks of their bank.” (Pillar 2, paragraph 16, p. 9191)

Again, it would be helpful to have language clarifying that subsidiary bank Board members need not have highly technical risk measurement backgrounds to satisfy the governance requirements.

#### H. Stress Testing of Risk-Based Capital Requirements.

Chapter 8 of the Guidance expands upon the NPR’s requirement that banks must stress test inputs into their risk-based minimum capital requirements. This is clearly intended as a Pillar 1 requirement as indicated within the NPR (which does not address Pillar 2) and within the Framework. This Pillar 1 stress testing is also clearly in addition to Pillar 2 requirements (per S 8-1 footnote 15 and Pillar 2 guidance footnote 11) We are highly concerned that the prescriptiveness of the Chapter 8 language might result in stress testing requirements under Pillar 1 that will be significantly different and quite possibly broader in some respects than yet-to-be-determined risk-based capital stress-testing requirements for ICAAP purposes (under Pillar 2). We oppose such Pillar 1 stress tests for reasons stated below. If this additional requirement must be retained in the short run due to the inclusion of this requirement in the Framework, we would greatly prefer that the language of the Framework (paragraph 435) be substituted for the less clear and more prescriptive language of Chapter 8 with regard to stress-testing.

Our concern is amplified because of the confusing rationale for any Pillar 1 stress test. In particular, what does the bank actually do with the numerical results of any Pillar 1 stress test? Nowhere in the NPR or the Framework is it suggested that Pillar 1 minimum capital requirements would be altered by the outcome of the Pillar 1 stress test. Nor should such an alteration occur. The apparent but unstated objective is to insure that the bank’s overall level of capital is sufficient to allow the bank to meet its Pillar 1 minimum capital

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<sup>11</sup> In just one example -- AMA governance -- there is specific reference to control infrastructure: “The board of directors must at least annually evaluate the effectiveness of, and approve, the bank’s AMA System, including the strength of the bank’s *control* infrastructure (emphasis ours).” This seems like an example in which the expertise of board members would be insufficient absent internal or external advice.

requirements in a mild stress period.<sup>12</sup> That is, the Pillar 1 minimum capital requirements are what they are, so long as the bank employs acceptable practice in estimating the various risk parameters.

During stress periods, one can indeed expect minimum capital requirements to rise (as, for example, loans migrate into grades or segments with higher PDs). This cyclical nature of minimum capital requirements may influence the bank's setting of its internal capital adequacy under ICAAP – as stated under the Guidance's Pillar 2 discussion (Paragraph 30, p. 9192):

“The level of capital deemed adequate by an ICAAP might also be influenced by a bank's intention to hold additional capital to mitigate the impact of volatility in (minimum) capital requirements...” (clarifying word “minimum” is ours).

So, it is clear that, under Pillar 2, the level of internally-determined capital is expected to result in higher internal capital requirements than the Basel Pillar 1 minimums during good times, partly because the minimums can be expected to rise during bad conditions. Thus, stress testing of the minimum capital requirements clearly would be part of numerical determination of appropriate internal capital levels under Pillar 2, but the additional S8-1 test under milder stress conditions serves no *additional* numerical function under Pillar 1. We conclude that both the NPR and the Framework erred by discussing stress tests under Pillar 1, and that any specificity at all with regard to stress testing should be reserved for Pillar 2 guidance.

To summarize, we see the current situation as one in which the Guidance requires the bank to perform expensive separate stress testing to satisfy Chapter 8 in addition to the stress testing needed under ICAAP (Pillar 2). This possibility can be lessened in the short run by the Guidance relying on the Framework's broad language (paragraph 435) when discussing stress testing in Chapter 8. The possibility could be lessened permanently and more appropriately via international agreement that stress testing of minimum credit risk capital requirements be a specific component of the Pillar 2 process of determining overall capital adequacy – and that stress testing requirement(s) be eliminated completely from Pillar 1.

#### I. Supervisory assessment of capital adequacy (ICAAP).

The discussion in the Guidance regarding the supervisory assessment of capital adequacy (page 9190, paragraph 8) says that “On an ongoing basis, the supervisory assessment process determines whether a bank's overall capital remains adequate as underlying conditions change. Changes in a bank's risk profile or in relevant capital measures are areas of particular focus that are effectively addressed through the supervisory review

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<sup>12</sup> “For this purpose, the objective is not to require banks to consider worst-case scenarios. The bank's stress test in this context should, however, consider at least the effect of mild recession scenarios.” (Par. 435 of the Framework)

process. Generally, material increases in risk that are not otherwise mitigated should be accompanied by commensurate increases in capital.”

We certainly agree that increases in a bank’s risk profile (in terms of the inherent risk content of its mix of business) should cause the bank to hold commensurately more capital. However, nothing in this Guidance should be interpreted as meaning that, as an economic downturn occurs, the bank should hold more capital. Rather, the major focus of the ICAAP requirement is that a bank should assess its ability to remain at least adequately-capitalized during adverse conditions. Thus, stress testing and other devices should be used to estimate the amount by which actual bank capital should a) exceed regulatory minimum capital as a generality, and b) constitute a cushion during good times that can be used to absorb losses and increased systemic risk that occur during bad times. The capital cushion during good times could not serve its purpose if it were required to be maintained during bad times. Indeed, most observers view a decline in this capital cushion as the first line of defense in a recession or idiosyncratic event, to be followed by the use of other tools – such as dividend reductions or asset sales – if circumstances become especially harsh.

Clarifying language on this point should be included in the discussion of ICAAP.

#### J. Seasoning in Retail.

The NPR’s treatment of seasoning is further refined within the Supervisory Guidance. This specific treatment stands in strong contrast to the Framework, in which banks are simply cautioned to consider seasoning within the process for segmentation and/or estimation of risk parameters (paragraphs 402 and 467 of the mid-year 2004 text).

The U.S. Supervisory Guidance provides some factors that should be considered when determining whether age or seasoning is material (paragraph 70, Chapter 4). This discussion is quite helpful, although the factors to be considered appear to be written more as “exceptions” to the use of seasoning treatment.

Paragraph 71, Chapter 3, then goes on to suggest that seasoning is material if a simple single-variable analysis is performed (in which, for a segment, the average of one-year PDs for the segment (over the number of years of available data) is found to be lower than the annualized cumulative default rate observed for the segment. A particular example of this notion is given in Example 4 on p. 9119 of the Federal Register text.

Our concern is that such single-variable analyses are highly likely to lead to an inappropriate conclusion that age is “material.” Often, multivariate analysis shows that, when other explanatory variables are included in the analysis (such as behavioral scores, delinquency status, etc.), age drops out (becomes statistically insignificant). The Guidance should be clarified on this matter to indicate that univariate analysis may not be appropriate, in and of itself, but that some proper analysis – including analysis of the



factors now in the Guidance -- should be conducted by the AIRB bank to determine whether seasoning is material.

Finally, if seasoning is shown to be material, we should note that using the observed annualized cumulative default rate (“ACDR”) for a segment is not the only method for taking seasoning into account. Alternative methods include, for example, the specific use of account age as an explanatory variable in the determination of loan level cumulative default probability estimates, followed by translation of those loan-level cumulative PD estimates into annualized cumulative PDs. Still other methods are reasonable, including ones that result in conservative, product-level remaining-life estimates, rather than segment-level estimates. Thus, the Guidance should avoid prescription in this arena in order to reduce compliance costs to acceptable levels.

#### K. Segmentation in Retail.

The NPR and Guidance require that retail segments must have “homogeneous risk characteristics” (NPR Section 22(b)(3) and Guidance S3-2). We understand the intent of this requirement, but its specific wording may be problematic. The problem is that the phrase “homogeneous risk characteristics” is often thought of as referring to risk factors of the obligor or the facility (size of balance, LTV, FICO score, delinquency status, etc.). When viewed in this context, it may appear as if the only way to form retail segments is in relation to such obligor-facility factors. However, we have been told by supervisors that nothing in the NPR or Guidance should preclude an AIRB bank from estimating risk parameters at the level of the individual retail loan, then aggregating these estimates into segments, each of which consists of a particular PD-LGD range.

Several best-practice institutions have developed their PD-LGD estimations in this direction, as a natural outgrowth of their internal risk measurement procedures. In these processes, PDs and LGDs are estimated at the level of the individual loan (e.g., via logistic regression) as functions of the many risk characteristics such as FICO, delinquency status, LTV, etc. The loan-level risk parameter estimates are then aggregated into PD-LGD cells for Basel II reporting purposes. Further, the new proposed Call Reports require that Basel II exposures be reported in a matrix of PD-LGD cells. The result is a set of segments in retail that are similar in form to the PD and LGD grades in wholesale. Loans of similar risk are grouped within the same cell – but, while two loans may have, say, the same PD, they may have differing risk factors (one loan has a high LTV but also a high FICO; another loan may have a low FICO but also a low LTV).

Additional language in the Guidance that clarifies this distinction in how best-practice banks define their retail segments would be helpful.

#### L. Mapping in Retail.

The Guidance’s discussion of mapping, especially in the context of retail segments, is at times unclear. For example, Chapter 4, paragraph 78 states:

“Key drivers of default should be factored directly into the obligor rating or segmentation process. But in some circumstances, certain effects related to industry, geography, or other factors are not reflected in wholesale obligor risk rating assignments, retail segmentation, or default estimation models. In such cases, it may be appropriate for banks to capture the impact of the omissions by using different mappings for different business lines or types of exposures. Supervisors expect this practice to be transitional, and that banks eventually will incorporate the omitted effects into the wholesale obligor risk rating, the retail segmentation system or the PD estimation process as they are uncovered and documented, rather than adjusting the mapping.”

We are at a loss to understand this paragraph and seek clarification.

Moreover, an overview treatment of circumstances in which mapping needs to be emphasized or updated would be useful. Discussions with supervisors indicate that mapping becomes an issue in circumstances where

- There has been a need to use external data to supplement the internal data;
- Data are bi-furcated due to something like a definitional change in the database (e.g., the use, in earlier years, of a definition of default that does not conform to the NPR’s definition);
- Product composition differs between the current portfolio and the reference database;
- The nature of obligors differs between the current portfolio and the reference database (e.g., a significant change in the portion of the current portfolio involving loans to obligors with very low FICOs)

We agree with this view and believe that mapping – between the reference database and the current portfolio – should be emphasized both at the point of initial model development and whenever the relationship between the reference database and the current portfolio changes in some significant fashion. However, a new mapping exercise need not be conducted every time the risk parameters are re-estimated.

#### M. Time Schedule for Implementation of Basel II in the U.S.

An implementation schedule was not addressed within the Guidance. Preferably, guidance on the schedule and step-by-step process of implementation should be published well prior to the date on which the final rule becomes effective.

### III. Chapter-by-Chapter Comments.

The following comments are in addition to those issues listed in Section II above. Please note that, for some of our members, the issues in this chapter-by-chapter discussion may rise to “highest concern” status.

#### A. Chapter 1: Overview.

No additional comments.

#### B. Chapter 2: Wholesale Risk Rating Systems.

1. Expert judgment systems. Greater clarity is needed in the language dealing with expert judgment systems. In particular, Chapter 2, paragraphs 5-7 indicate that, in such systems, two individuals exercising judgment could, looking at the same information, arrive at different ratings for the same obligor. This flexibility is a key characteristic of such systems. However, Chapter 7, S-11, paragraph 38, dealing with controls and validation, says that “Judgmental overrides” occur when judgments are made to reject the decision of an objective process, such as a model or scorecard, which rates a wholesale obligor, assigns an exposure to loss-severity rating grade, or assigns an exposure to a retail segment; judgmental overrides are an explicit component of such a rating system’s design. As a matter of policy in a constrained judgment rating system for wholesale lending, a rater is generally allowed to adjust or override the results of a statistical rating model. For retail lending, the assignment of an exposure to a segment could be overridden, but such overrides generally are rare.”

We seek clarification that in “pure” expert judgment systems, the term “judgmental override” is not applicable. In constrained judgment systems, further, a “credit score” might be one of the variables to be considered by the rating officer but, unless there is specific bank policy to the contrary (such as a requirement that the rating cannot be more than x clicks above the rating implied by the score), “judgmental override” would not be applicable with respect to that score. More generally, “override” would be applicable only to the extent certain grades are not generally permitted for obligors for which one or more risk characteristics are outside of a designated range.

2. LGD estimation based on collateral value. Chapter 2, paragraphs 37 and 40 appear to indicate that supervisors expect LGD ratings or buckets to depend not only on the type of collateral or facility but also on the level or value of collateral. We seek confirmation that, in the absence of statistically significant evidence to the contrary (which the bank would seek to uncover), a single LGD value for a single product or collateral type is satisfactory. Note that this issue exists both with respect to non-cash collateral values in wholesale lending as well as with respect to collateral values for retail loans such as mortgage products.

### C. Chapter 3: Retail Segmentation Systems.

Segmentation to avoid the 10 percent LGD floor. Chapter 3, paragraph 13, indicates that banks “should not artificially group exposures into segments specifically to avoid the 10 percent LGD floor for mortgage products.” While we can understand this concern, we would like to point out that the 10% LGD floor, if interpreted by the Guidance to apply to each segment, has the unintended effect of dissuading banks from segmenting in great detail.

For example, segmenting below the national level might uncover geographic regions for which house price declines lead to higher LGDs than on the national level, while in other areas the reverse may be true. If the bank uncovers a segment for which measured LGD is less than 10%, the economics might call for the bank to expand in this segment relative to other segments, yet such effort will be rewarded by an arbitrary increase in capital – a clear unintended consequence. This effect may be compounded by use of the Supervisory Mapping Function, which causes LGD to be a high multiple of low ELGDs.

We recommend that supervisors continue to monitor the unintended consequences of both the 10% LGD floor and the SMF for low LTV loans. Banks should be encouraged to continue to originate low risk loans. In mortgages, for example, low LTVs may result both in low LGDs and low PDs, and should be rewarded with appropriately low capital requirements.

### D. Chapter 4: Quantification.

1. S4-1: “..... Documentation promotes consistency and allows third parties to review and replicate the entire process.” We agree that documentation is vitally important to the review process. However, some processes may be viewed as proprietary (for example, source code). Therefore, we suggest that documentation be sufficient to review and “assess” the process, rather than “replicate” the process.
2. S4-2: “Risk parameter estimates must be based on the IRB definition of default.” We agree that a consistent definition of default should be applied (subject to our earlier concerns over the nature of the definition). However, practical considerations argue for leeway in applying filtering criteria (e.g., filters intended to catch the misidentification of accounts as “defaulted”). For example, an account may be misidentified as 120DPD (in Other Retail), then appear the next month as current. While it is possible that the account actually did default and then “cure,” the bank should not, in every instance, have to manually verify whether a “cure” took place or whether there was a mis-identification of default in the first place. Data-based filters can reasonably substitute for such expensive manual effort, so long as supervisors do not inflexibly require the application of the default definition.

3. “Judgmental adjustments are not to be biased toward lower risk parameters.” (S4-11).

In some cases, a judgmental downward adjustment may fit the logic of the situation without necessarily being biased. For example, in asset-based lending, ELGDs may first be estimated for collateral in which there is no daily or weekly monitoring of collateral value. Then, a downward adjustment to these estimated ELGDs might be applied to facilities for which such frequent monitoring exists. Historical data on the well-monitored facilities may not yield good estimates of ELGD in the absence of such judgmental adjustment, because of the lack of loss data. We seek confirmation that such downward adjustments will not be viewed by supervisors as “biased” simply because the adjustment is in the downward direction.

4. Paragraph 109, Chapter 4, states that “All costs, and recoveries should be discounted to the time of default using the time interval between the date of default and the date of the realized loss, incurred cost, or recovery; this calculation should be on a *pooled* basis for retail exposures.”

Supervisors have indicated that this “pooled basis” requirement does not preclude in any fashion the use of individual defaulted asset cost and recovery data in estimating LGDs (e.g., through regression analysis). We seek clarification of the language in the Guidance that such loan-level estimates would satisfy the “pooled” requirement by being aggregated up to the segment level, so that a single ELGD and LGD would be associated with each segment.

5. Defaults on obligations not held by the bank. We seek clarification that a) a default on an obligation of a borrower, in which the bank does not hold that obligation, does not *necessarily* trigger “default” on the bank’s exposures, but that b) declaration of bankruptcy *may* trigger a “default” grading of the bank’s exposures to the obligor.

6. EAD treatment.

- a. We seek confirmation that for term loans, with or without scheduled amortization, but with no “line of credit” feature, EAD may equal 100% of current balance (including unpaid interest and fees).
- b. S4-24 and paragraph 150 indicate that estimates of additional draw-downs prior to default cannot be negative. We seek confirmation that this means “cannot be, on net, negative.” This is tantamount to saying that EAD cannot be less than current balance outstanding (including unpaid interest and fees).

7. Chapter 4, paragraph 18 (last sentence) indicates that private mortgage insurance is considered a guarantee, for which the result may be an altered estimate of PD or LGD. We seek confirmation that, by extension, private student loan insurance/guarantees also merit guarantee treatment. Similarly, the Guidance's treatment regarding credit quality deterioration of a private mortgage insurer (paragraph 21) also applies to other guarantors.
8. Since de minimus positions are not subject to AIRB treatment (and receive current risk-weight treatment such as 100%), we seek clarification that such positions do not require periodic review for purposes of re-grading as in the case of AIRB positions.
9. Parameter estimation in the context of national jurisdiction. (Paragraphs 121-122). We seek clarification that, while national jurisdiction risk parameter segments may be required, this does not preclude the use of generalized loan-level PD estimation equations (with appropriate dummy and interaction terms for national jurisdictions). Rather, the national jurisdiction requirement pertains to calculation and reporting of risk parameters and/or regulatory capital requirements, not best-practice estimation of such parameters. To be specific, if generalized estimating functions provide for better statistical fit, such better-fit equations are permissible in determining the slope and intercept terms for the effect of explanatory variables on risk parameters in various countries.
10. We seek confirmation that the requirement in Chapter 4, paragraph 5 – that “statistical techniques” should be used to determine the relationship between risk characteristics and the estimated risk parameter – does not conflict in any fashion with the Chapter 3, paragraph 7 statement that “expert judgment” may be used to determine the relevant risk drivers for segmentation.
11. S4-6 says that the quantitative process and the risk parameter estimates must be “reviewed annually and updated as appropriate.” This is less burdensome than requiring annual updating of the risk parameter estimates. Note, however, that the “annual review” might not need to be substantial for many sub-portfolios where there has been no change in product or obligor composition, nor any change in the underlying data (other than the addition of one more year's worth of data) which could be expected to change significantly the parametric estimates. Therefore, limited review personnel might more effectively spend their time on sub-portfolios for which loss data are more problematic or where mapping or other issues may be more likely to arise.
12. Language regarding treatment of risk management changes appears to be somewhat asymmetrical. (Paragraph 30). Specifically, “The risk parameter estimates may be particularly sensitive to changes in the way banks manage exposures. When such changes take place, the bank should consider them in all steps of the quantification process. Changes likely to significantly increase a risk

parameter value should prompt increases in the risk parameter estimates. When changes seem likely to reduce the risk parameter value, estimates should be reduced only after the bank accumulates a significant amount of actual experience under the new policy to support the reductions.”

We believe that such asymmetry (between the last two sentences above) is antithetical to the regulatory objective of having the AIRB approach be truly risk-sensitive. As a practical matter, the degree to which risk management change occasions change in risk parameter estimates, in either direction, should depend on the facts and circumstances, including but not limited to 1) the ability of the bank to statistically estimate the appropriate parametric change, 2) the bank’s judgment that such statistical estimation may be inaccurate until the bank has gained experience with the effects of the management change, and 3) the comfort level with the degree of conservatism embedded in the process using either current, future, or interim risk parameter estimates (whether higher or lower than current estimates).

E. Chapter 5: Wholesale Credit Risk Protection.

See our comments under Section II E above, on guarantees.

F. Chapter 6: Data Management and Maintenance.

No comment.

G. Chapter 7: Controls and Validation.

1. Use tests. We congratulate the supervisors on the provision of more practical language involving so-called “use tests.” In this Guidance, the key appears to be that the internal AIRB approach must be “consistent” with internal risk measurement and management procedures. This allows for greater flexibility and lower cost of compliance, without compromising the ability of the new regulatory capital standards to achieve prudential objectives.
2. S7-4 – Validation activities must be conducted independently of advanced systems’ development...or subjected to an independent assessment. We are in agreement with this general requirement. We seek clarification that regularly scheduled benchmarking and back-testing need not be conducted by other than the modeling staff. The independent validation or assessment of validation needs to be conducted only when the modeling staff has decided upon a material change in methodology, data, or implementation procedures.
3. S7-6 -- Internal audit must at least annually assess the effectiveness of controls. The audit process would become extraordinarily expensive if it were required for every component of controls, even those that, a year ago, were deemed to be

without significant gaps. Rather, the audit process should concentrate annually on less well developed or more risky control processes. Other portions of the control process could be reviewed by audit every 2 years.

4. S7-9 – Validation processes must include the evaluation of conceptual soundness, ongoing monitoring, and outcomes analysis. We agree with this general provision. We seek confirmation that the bank does not need to explain, within its validation documentation, why every “model” attempt -- other than the finally-accepted one -- was rejected. Research into risk parameterization is an iterative process, and only the rejection of the serious contenders should be documented. Documentation is inherently a very expensive process and needs to be focused on only the major, and more widely accepted, possibilities in comparison to the chosen approach.
5. S7-14 – Banks should establish ranges around estimated risk parameter values and have a validation policy that requires assessing the reasons for differences between actual outcomes and estimated values. The bank should also develop a set of remedial actions when results fall outside expected ranges.

We agree with the need for outcomes analysis as part of the validation process. However, we view such analysis as being based on multiple observations, not any single observation or set of observations that are “outside expected ranges.” For example, out-of-time tests are appropriate as part of outcomes analysis. But nothing in the Guidance should suggest that a single observed high (or low) segment default frequency, or even a few observed high or low segment default rates, for example, should trigger “remedial action.” A few observations of a high segment default rate (for a given quarter or a given year or a couple of years) could be perfectly consistent with the estimated through-the-cycle PD being used for that segment.

Indeed, as expressed within the Basel II credit risk models, individual segment default frequency outcomes are related not only to expected default frequencies (PDs), but also to AVCs. Thus, segments with high AVCs should experience, other things equal, more volatile default frequency observations. Setting some range for “acceptable” realized default rates for a segment cannot be done outside the context of the credit risk model itself. Rather, conceptually, a hypothetical “bad draw” of a single macro factor could easily result in a segment’s default rate being many times higher than the (properly estimated) expected default frequency.

We therefore recommend deletion of language in the Guidance that characterizes outcomes analysis – the 3<sup>rd</sup> leg of the validation “stool” -- as requiring “remedial action” if default frequency observations are outside “acceptable ranges.” Rather, outcomes testing should be conducted on a periodic basis using standard statistical tests, such as out-of-time tests, and should involve reasonably large sets



of individual segment realized default frequency outcomes.<sup>13</sup> Additionally, particularly high or low outcomes might initiate an analysis of why the outcome occurred (e.g., due to a “bad draw” of a macro risk factor), but such an analysis might not lead to any action with regard to the risk parameter estimation process. Standard statistical tests should determine whether new outcomes (and never a single new outcome) imply a need to re-estimate the risk parameter.<sup>14</sup>

#### H. Chapter 8: Stress Testing of Risk-Based Capital Requirements.

See our comments in Section II H above.

#### I. Chapter 9: Counterparty Credit Risk Exposure.

No comment.

#### J. Chapter 10: Risk-Weighted Assets for Equity Exposures.

See our comments in Section II F above, along with comments under Chapter 11 (Securitization).

#### K. Chapter 11: Securitization.

We object to what appears to be the use of securitization treatment as the over-arching treatment for exposures that are not specifically identified and treated elsewhere within the AIRB approach. S11-1 indicates that securitization applies to any case in which there is a “tranching of credit risk” (except for a tranching of a guarantee of an individual retail exposure). But the concepts of “tranching” or “securitization” are not sufficiently defined in the NPR or Guidance in a manner that is consistent with the market’s use of these terms.

The NPR also specifically attempts to exclude “non-financial” assets from securitization treatment: “As noted above, for a transaction to constitute a securitization transaction under the proposed rule, all or substantially all of the underlying exposures must be financial exposures.”<sup>15</sup>

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<sup>13</sup> Our concern also applies to the validation of ELGDs and LGDs. Again, realized losses-given-default for a segment can vary over time according to the effects of the macro factor(s), including unseen or unidentified factors. As new observations of LGD are accumulated, out-of-time tests become possible, but no individual LGD observation or small set of observations should, in and of itself, spark “remedial action” due to the observed LGD being outside of some range.

<sup>14</sup> Note that the existing capital rule for market risk in the trading account takes into account the number of “exceptions” associated with realized daily market losses. The capital charge is based on a “multiplicative factor” which in turn is based on the number of “exceptions.” But this “back-testing” rule was intended to be a check on the capital calculation flowing from the risk model itself (the bank’s VaR model), not a check on a model that estimates one input into a risk model (i.e., a TTC PD).

<sup>15</sup> P. 55860, Federal Register NPR, September 25, 2006. We have previously commented on Question 26 of the NPR in reference to this specific “non-financial” asset condition.

As a result, the Guidance and NPR attempt to apply securitization treatment to cases in which market participants believe the economics do not justify such treatment – with the result being both high compliance costs associated with securitization treatment, and higher regulatory capital requirements than suggested by the economics. Conversely, the Guidance also attempts to deny appropriate securitization treatment in cases where the economics calls out for securitization treatment.

We begin by offering a generalized view of securitization. Often, we think of securitization as applying to a case in which a pool of assets – whether “financial” or “non-financial” in nature – is financed via the issuance of various classes of securities in a Special Purposes Vehicle (“SPV”). Each tranche of issued securities has a different degree of seniority, in terms of its claim on the cash flows emanating from the underlying pool of assets. We generally agree with regulators that, because of the degree of possible correlation between asset values in the underlying pool – and because of the possible correlation between values of each tranche and the values of assets in the overall portfolio of the bank holding a particular tranche – securitization tranches deserve special treatment compared with individual bank holdings of one or more of the underlying assets in the securitized pools.

We also agree with regulators that the legal structure of the tranching is not at issue – it does not matter whether the securitization is via a SPV or via a synthetic securitization -- the capital consequences of securitization should apply.

However, we disagree with regulators over what types of economic structures should be termed “securitizations”, over what types of underlying assets should be “eligible” for securitization treatment, and whether application of securitization should depend on whether we are talking about a single underlying asset or a pool of underlying assets. Our concerns cover several areas of the securitization chapter as well as the chapters dealing with securitization treatment of tranching guarantees and the possible securitization treatment of certain investment funds. These topics have been introduced in earlier sections of this response.

First, so long as a single asset or a pool of assets involves some potential cash flow now or in the future, the concept of securitization might apply, no matter whether the underlying is “financial” or “non-financial”. As we indicated in our response to the NPR, the use of the “non-financial” distinction is potentially constricting on future market developments.<sup>16</sup> Even now, some existing securitizations might involve what regulators consider to be “non-financial” assets.

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<sup>16</sup> “Our major concern is that the requirement (in the NPR) not stand in the way of the development of innovative securitization structures, especially those that including underlying positions that are “non-financial” under the regulatory definition of such assets. We suggest that, in general, if NRSROs either 1) have established defined rating criteria for the underlying positions, or 2) have rated one or more tranches of the securitization, the Basel II bank should be

Second, securitization should apply generally to cases in which “tranching” of credit risk involves differing degrees of *default probability* for the tranches themselves. In the traditional securitization, for example, the performance of the underlying assets could generate cash flows which, at some point in time, become insufficient to pay off scheduled principal and interest payments on all tranches. In this case, the junior tranches can effectively default and would not receive their scheduled payments, while the senior tranches would continue to receive everything due them and would not enter default status.

Conversely, a “structured financing” of, say, a single “non-financial” asset such as a revenue producing project, might involve several lenders, all of whom would contractually suffer default if the cash flows from the underlying asset fall to too low a level. In such a case of default, the realized losses-given-default of the individual lenders would differ depending on their seniority in the structured finance hierarchy. Such a hierarchy should not in itself trigger “securitization” treatment (and does not under the current proposal, because the underlying in our example is defined as “non-financial”). Rather, the hierarchy of the transaction triggers careful ELGD and LGD estimation by the participants -- each bank’s LGD differentiated according to its position in the hierarchy.

However, we believe that a structured financing of a single *financial* asset, or a pool of financial assets, should also not trigger securitization treatment, so long as each of the tranche holders is subject to a single default condition. As in the case of the structured financing of the project, the existence of a common default condition for the tranches should, rather than trigger securitization treatment, involve a hierarchy of LGD estimates for each of the tranches.

Third, in the case of a tranching guarantee of a pool of financial assets, as discussed in section II E above, we believe that, when there is a single guarantor, a single guarantor position, and a single owner of the pool being guaranteed, securitization treatment might reasonably be avoided. For the guarantor, as we have indicated, the bank should always have the option of simply computing regulatory capital as if the bank owned the pool of assets. For the bank receiving the benefits of the guarantee, such a “no-guarantee” option should also exist. However, in addition, we should consider that the receiver of the

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permitted to use securitization treatment on the same grounds as securitization of “financial” positions. As such, the securitization treatment for pools of such “non-financial” assets could include the RBA for rated or inferred-rating tranches; the IAA for ABCP tranches; the SFA for unrated tranches; or deduction for positions that are not eligible for any of the other treatments. Examples of such “non-financial” underlying positions might include:

- Revenues from intellectual property rights
- Entertainment royalties
- Project finance revenues
- Leased equipment residuals”

guarantee, even if the guarantee is “tranching” (i.e., even if it does not involve a simple percentage coverage of all losses), could reasonably calculate a downturn LGD for the underlying assets (in the event of a downturn default rate and application of the guarantee) – see footnote 8 above.

Fourth, we are generally concerned that whenever the bank must either use the Supervisory Formula or take a capital deduction (whether in the case of a guarantee or a traditional securitization), it may be the case that the bank does not have complete information on the underlying assets to calculate the components of the SF in the same manner it would if the bank owned the assets. At times, this is because the bank is not performing a servicing function and/or did not originate the underlying assets. For such cases, we would prefer that the Guidance specifically note that there is wide flexibility in risk parameter estimation procedures that could be applied to available data on the pool assets. For example, mapping procedures could permit application of internal bank information on its own assets that have some or all of the characteristics of the pool assets. Or, the bank may use a “top-down” approach in which data on pool assets provided by, say, rating agencies could be used to infer SF components. For example, pool aggregate or segment data could first be used to estimate expected loss rates, then the bank could apply a conservative assumption about LGD to “back into” PD estimates. So long as the bank uses conservatism to compensate for lack of full loan-level data, the result should not be automatic capital deduction treatment.

Fifth, we are concerned that neither the NPR nor the Guidance discusses a treatment of “investment funds with material liabilities.”<sup>17</sup> We understand that regulators may be considering securitization treatment for such investment funds (possibly via defining the term “hedge fund” and applying securitization treatment to such funds). Such treatment would be consistent with what we see as a possibly emerging regulatory view that securitization should be applied when consensus on some other reasonable treatment has not been achieved or when, for whatever reason, the regulators have a concern over the risk of a specific type of exposure. We would not support such a view.

In the case of any investment fund with any degree of leverage, the leverage should indeed be considered when allocating capital to the bank’s exposure to the fund. But securitization treatment, to us, would not apply unless the liabilities of the fund, like those of the typical SPV, involve varying default conditions for the owners of those “tranches.” For the bank simply holding a piece of the fund’s equity, one of the “look-through” approaches may be appropriate, subject to the condition that in no circumstance would the bank’s regulatory capital allocation for its position exceed the amount of its exposure.

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<sup>17</sup> The NPR defines an investment fund (for purposes of using investment fund treatment) as: “a company all or substantially all of the assets of which are financial assets and which has no material liabilities.” (p. 55899, Federal Register NPR, September 25, 2006).

Additionally, we remain concerned that application of a Simple Risk-Weight Approach to the bank's exposure to an investment fund, with or without material liabilities, is fraught with the possibility of over-reaction by regulators. We are especially concerned that any risk-weight applied to an equity piece of a leveraged investment fund should not be significantly higher than the risk-weight of 400% applied to an equity position in a private company (including a private financial company). As we have discussed at length in our response to the NPR,<sup>18</sup> risk-weights approaching 1000% are comparable to a capital deduction, while a risk-weight of 1250% is clearly quite punitive. We are therefore quite concerned about the possibility that regulators might require use of the SRWA for a defined "hedge-fund," and we would be especially opposed to such a SRWA involving a weight much higher than 400% or involving a weight that varied with a simple measure of leverage.

Finally, note that the Capital Working Group has not had sufficient time to reach consensus on the definition of a hedge-fund or, for that matter, whether such a definition is even needed. We do wish to point out, however, that what we typically regard as hedge funds are generally structured as limited partnerships (with the investor as a limited partner). Thus, the liability exposure of the bank in such a fund is limited to its investment.

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<sup>18</sup> See Appendix 3, "Comparing a 1250% Risk Weight to a Capital Deduction," RMA Response to the U.S. Notice of Proposed Rulemaking Regarding the Basel II Capital Regulations, March 26, 2007.

Attachment 1

Board of Directors – Summary of Basel II Responsibilities

	<b>Requirement</b>	<b>Timing</b>	<b>Source(s)</b>
1.	Board (or a designated committee of the board) must evaluate the effectiveness of and approve the bank's advanced systems.	At least annually	[SG] CR-S 1-3 [NPR] Section 22(j)(2)
2.	Internal audit must assess the effectiveness of the controls supporting the IRB system and report its findings to the Board (or a committee thereof).	At least annually	[SG] CR-S 7-6
3.	The Board must approve the bank's written implementation plan to comply with qualification requirements	One off	[SG] Appendix C, B8 [NPR] Section 21.b.8
4.	The Board must evaluate the effectiveness of, and approve, the bank's AMA System, including the strength of the bank's control infrastructure.	At least annually	[SG] OR- S 4
5.	Banks may use independent and qualified internal (e.g., internal audit) or external parties to perform verification and validation. These functions should assess and report to the Board on the adequacy of the overall AMA System.  Appropriate reports summarizing the results of independent verification and validation of the bank's AMA System, including associated models, should be provided to the Board and appropriate management. The board should ensure that senior management initiates timely corrective action where necessary.	Annual	[SG] OR- S 32
6.	The Board and management should ensure that the bank's operational risk management, data and assessment, and quantification processes are appropriately integrated into the bank's existing risk management and decision-making process and that there are adequate resources to support these processes	On-going	[SG] OR-S 5

	throughout the bank.		
7.	The Board and senior management must receive reports on operational risk exposure, operational risk loss events, and other relevant operational risk information. The reports should include information regarding firm-wide and business line risk profiles, loss experience, and relevant business environment and internal control factor assessments.	Quarterly	[SG] OR-S 10
8.	Board must adopt formal disclosure policy that addresses the bank's approach for determining the disclosures it should make.	One off	[MR] Section 8(b) [NPR] Section 71
9.	The Board or its appropriately delegated agent should approve the ICAAP and its components, review them on a regular basis, and approve any revisions.  The Board or its delegated agent, as well as appropriate senior management, should periodically review the resulting assessment of overall capital adequacy and determine that actual capital held is consistent with the risk appetite of the bank, taking into account all material risks.	Periodically	[SG] Pillar 2, #37 [SG] Pillar 2, #41

Key:

SG = Supervisory Guidance

MR = Market Risk NPR (9/5/06)

NPR = Credit and Operational Risk NPR (9/5/06)

## Appendix

### **Institutions in the RMA Capital Working Group:**

ABN AMRO	Bank of America
Barclays	Capital One
Citigroup	Comerica
Countrywide	HSBC/North American Holdings
JPMorganChase	KeyCorp
M&T	RBC Financial
State Street	SunTrust
Union Bank of California	U.S. Bancorp
Wachovia	Washington Mutual Bank
Wells Fargo	

### **Staff participating in preparation or review of this paper:**

**Bank of America:** John S. Walter, Senior Vice President, Risk Capital & Portfolio Analysis

**Capital One:** Geoffrey Rubin, Vice President, Strategic Finance; Lin Li, Senior Manager, Strategic Finance; William Nayda, Senior Director, Strategic Finance

**Citigroup:** Fenton Aylmer, Director, Basel II Risk and Regulatory Oversight

**HSBC/North America Holdings:** John Zeller, Executive Vice President, Credit Risk Management; John Roesgen, Senior Vice President, Risk Management; Stephen Mongulla, Group Director, Retail Credit Management; Jodi Richard, Group Director, Corporate Risk; Mary Ann Hageman, First Vice President, Credit Risk Management

**JPMorganChase & Co:** Adam Gilbert, Managing Director; Michel Araten, Senior Vice President; Joseph P. Lyons, Vice President; Michelle Rosenthal Hubertus, Vice President

**KeyCorp:** Robert Kula, Senior Vice President; Thomas Boltja, Vice President

**RBC Financial:** Lyn McGowan, Managing Director, Basel Implementation Program; Chitra

Muralikrishnan, Senior Manager, Financial Policy and Economic Capital; Michael Cussen, Basel Coordinator; Jason Smith, Senior Manager, Credit MIS

**State Street:** F. Andrew Beise, Basel II Risk Management Content Leader; Norman J. Greenfeld, Director of Counterparty Review; Joseph J. Barry, Vice President, Regulatory & Industry Affairs; Kim Milosh, Basel II PMO

**SunTrust:** Toni Stanek, First Vice President, Enterprise Risk Management

**Union Bank of California:** Paul C. Ross, Senior Vice President, Enterprise Risk Reports/Analysis and Basel II Project Management Division Manager; Desta Gebre-Medhin-Huff, VP, Credit Portfolio Risk Analysis and Basel II Program Support; Jouni Korhonen, SVP, Portfolio Risk Management; Hans Helbekkmo, Senior Vice President, Enterprise Wide Risk

**Wachovia:** Gary Wilhite, Senior Vice President, Credit Risk Management; Avery Wise, Vice President, Credit Risk Management; David Harris, Program Manager, Basel II Executive Program Office



**Washington Mutual:** John Stewart, Senior Vice President; Kurt Wisecup, First Vice President; Amy Alexander, First Vice President

**Risk Management Association:** Pamela Martin, Director, Regulatory Relations & Communications

**Promontory Financial Group:** John Mingo, Senior Advisor