Response to the Proposed Shared National Credit (SNC) <p

Program Modernization

The RMA Capital Working Group

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I. Introduction and Overview.

The RMA Capital Working Group[1] appreciates this opportunity to respond to the December 7, 2004 interagency proposal regarding a program to modernize the Shared National Credit ("SNC") process. The Group is broadly supportive of the SNC modernization proposal ("the Proposal"), especially insofar as the Proposal, if implemented, would reduce the reporting burden of SNC institutions and/or the burden associated with hosting SNC examiners within the bank. We also support the associated objectives of providing uniformity in data submission and supervisory credit classifications across the four banking agencies that now participate in the SNC program, as well as promoting efficiency in the data collection effort.

The Proposal contains additional objectives, however, that may prove to be problematic. These include:

- Expansion of the SNC data collected from the banks that agent a significant volume of SNCs;
- The application by the agencies of advanced credit risk analytics and benchmarking techniques to common SNC borrowers, facilities, and reporting banks' portfolios; and
- Providing reporting banks with feedback on their commonly held SNC portfolios across these risk metrics.

Potentially, these new requirements may entail significant start-up and ongoing costs to the reporting institutions. The feedback, moreover, while potentially useful to the reporting banks, raises issues of confidentiality as well as the appropriateness of particular risk metric procedures. The Proposal does not go into detail with regard to the risk analytics that will be applied to the data by the agencies. Therefore, our concerns regarding the analytics, at this stage, are only very general in nature (see section III below). As the Proposal becomes more refined, we ask that the agencies continue to involve major reporting banks in the development of the new program, perhaps forming a working group to help address issues regarding technology, credit risk analytics, and cost.

II. Costs and Timing of Implementation.

Start-up costs. Even without the planned increase in amount of data to be collected, the new program would entail significant start-up costs. Moreover, start-up would involve many of the personnel involved in the Basel process and, in particular, the process of obtaining approved AIRB status for the institution. For this reason, we ask that the implementation of the new SNC program be delayed until after the start of the Basel II parallel calculation period (i.e., until after January, 2007), when most of the banks expected to be Expanded SNC Reporters will have substantially completed their Basel II preparations, including the final determination of database procedures needed to estimate PDs, LGDs, and EADs. It should also be remembered that at no bank is the credit risk data gathering process completely automated. With respect to the Basel II mandate, significant manual effort is needed and will be needed for the foreseeable future. Thus, the resource demands on the risk measurement functions at each of the reporting banks will be great. The impact on costs, and on the quality of the Basel II risk measurement process within each bank, could be alleviated by a planned *phase-in* of the proposed SNC program. The phase-in could include:

- A delayed start coupled with a staged implementation of the additional data fields.

- Raising the threshold for full-data submissions to apply initially to facilities greater than $20 million (e.g., start with $100 million).

- An initial data submission frequency of yearly (as is the case now), until data collection-and-submission procedures mature (thereafter, quarterly).

Whatever the process, it is important that supervisors not saddle reporting banks with a data collection and submission process for SNC that represents essentially an interim SNC solution that would conflict with the Basel process. That is, the first order of business for each bank should be to complete Basel II preparations – then, a phase-in of SNC modernization should take place, all the while taking care that the SNC modernization planning process is consistent with the newly matured Basel II risk-data procedures at the reporting banks.

One especially vexing start-up issue (and cost) would be to devise a common language into which to "translate" each bank's internal ratings. Translation issues will arise whenever the number of internal rating buckets differs from the number of buckets used by the major rating agencies (so that there can be no one-to-one correspondence). Indeed, it may not be necessary or desirable to devise a common rating language because of this inherent difficulty. Rather, numerical PDs provide essentially a continuous rating scale and, because Expanded Reporters all estimate PDs individually for each large credit, the reporting bank could provide only a range of PDs that corresponds to each of its internal rating categories. Note also that banks may differ with respect to the type of internal rating system in use – that is, the system may be through-the-cycle or point-in-time. The latter type of system might be engineered to have obligor ratings move significantly over the cycle. As a result, supervisors would need to know the type of internal rating system in order to be able to compare ratings for any particular credit. Moreover, information on the median of banks' internal ratings for any particular credit for any point in time, if disseminated, would have to be viewed with caution relative to, say, information on the range of banks' Basel PDs. See further discussion in Section IV below on feedback issues.

Ongoing cost issues. A primary objective of the SNC modernization should be that, when the SNC phase-in is completed, the costs to the reporting banks do not entail a significant marginal cost above the costs associated with remaining in Basel AIRB compliance. While the Proposal suggests that this marginal-cost issue is a major concern of supervisors, actual achievement of this objective will not be easy. We suggest several precepts that could help meet the zero-marginal-cost goal:

- The data collection formats associated with Basel should be the starting point from which the SNC format flows. The goal should be to achieve full automation of the SNC reporting procedure even though the Basel data gathering process itself may never be fully automated.

- Technology discussions related to SNC should not be permitted to take so long that final decisions occur close to the date of implementation. Put another way, the industry-wide implementation date (or the beginning of a phase-in period) should be timed to allow some significant length of time (after technology decisions are made) for the banks to complete their own planning and implementation processes. At least a year should pass after supervisors make the final decisions regarding procedures, before the first part of the phase-in begins.

- The supervisory agencies should assume as much of the burden of the modernization process as possible. For example, rather than have reporting banks decide when a datum meets the reporting requirements (such as whether a participant is a regulated entity) the regulators should make such determinations. Efficiency is maximized whenever the supervisory authorities can do a job once, rather than have several reporting banks duplicate the same task. In this regard, it may prove less costly, for example, for a reporting bank to provide a broader array of information which regulators could then winnow down, rather than have each bank engage in a winnowing process.

III. Benchmarking and Risk Analytics.

The additional data to be collected through the SNC reporting process includes Basel-related PDs, LGDs, and EADs, along with the internal borrower and facility ratings that may be used in arriving at loan-specific PDs, LGD, and EADs. As we have indicated, the Proposal is not specific with regard to how the supervisory agencies will use these new data. One such use could be to assist supervisors in evaluating the procedures AIRB banks use to estimate the key Basel-required risk characteristics of their loans. While it would be appropriate for supervisors to use the collected PD, LGD, and EAD data in this manner, we believe it would be inappropriate to use the data for the broader purposes of evaluating a bank's internal credit risk measurement and management procedures (i.e., it own Economic Capital procedures) or determining the overall adequacy of its capital under Pillar 2.

We take this view because the PDs, LGDs, and EADs estimated for Basel II purposes may differ very substantially from the best-practice estimation of PDs, LGDs, and EADs used for internal risk measurement and management purposes. For example, the LGD used for Basel purposes is supposed to be a downturn LGD, not the through-the-cycle ("TTC") default-weighted LGD in general use within banks' own internal economic capital models. Similarly, PD for Basel purposes is supposed to take account of long-cycle movements in default frequencies and may involve a weighted average historical default frequency for a particular internal rating grade, rather than a loan-level estimated PD. Similarly, Basel II imposes arbitrary restrictions on certain of the risk parameter estimation procedures (for example, EADs cannot be lower than the balance outstanding). Finally, the asset-value-correlations ("AVCs") used within the Basel commercial credit risk model – while broadly consistent with industry AVC estimates – may, nevertheless, differ substantially from the pair-wise correlations estimated by risk-measurement-practitioners for their own banks' portfolios.

For these reasons, we are somewhat skeptical of the Proposal's claim that "The ability to quantify and compare institutional risk across the same syndicated exposure or *portfolio* of commonly held exposures (i.e., a "benchmark") is one important benefit of the proposed changes." We are concerned that supervisors may attempt to draw inferences regarding a reporting banks' overall portfolio risk (i.e., economic capital) using Basel II risk parameter information that is, and should be, intended solely for purposes of establishing Pillar 1 minimum capital requirements. The Pillar 2 process – which should directly address the appropriateness of internal risk measurement procedures and the bank's overall capital adequacy (over and above the Pillar 1 minimums) – necessarily would require much more information than the Basel PDs, LGDs, and EADs associated with the subset of bank positions comprising on-balance-sheet, large, participated credits. We do not believe that the SNC process is the place for obtaining and analyzing this additional information.

We reach this conclusion because of the amount and complexity of the positions that impact importantly on portfolio risk and because of the great diversity of practice across AIRB banks in the manner in which they maintain and analyze these data in order to manage credit risk. Even the subset of the credit portfolio comprising large, shared credits is complex, since AIRB banks typically use a variety of credit derivatives, both in the banking book and the trading book, to manage the overall portfolio. In this regard there are significant differences between the requirements of Basel and common risk measurement and management practices. For example, no AIRB bank would ignore the double-default/double-recovery effect of guarantees when assessing portfolio risk or the marginal economic capital that should be allocated to a particular credit. Even for an un-hedged credit, two banks could assign the same PD, LGD, and EAD, but might apply different effective AVCs (due to the particular make-up of the two banks' portfolios). As still another example, note that Basel requires PDs to be assigned to the obligor and LGDs to be assigned to facilities. In contrast, in the case of loans collateralized by income-producing properties and certain receivables, practitioners might assign a facility-specific PD.

The Pillar 2 (supervisory) process necessarily will delve into such issues. However, it is important that each AIRB bank engage in its dialogue with supervisors by utilizing the bank's own internal management-information systems to support its views. The complexity of risk mitigation positions and the diversity of internal (not Basel) PD, LGD, and EAD estimation procedures, argue against using a common SNC program methodology for collecting these economic risk estimates.

Whether or not supervisors limit their SNC data requirements to address only the narrow concerns of shared credit classification and appropriate Basel risk parameter estimation, we would like to reinforce the view that diversity of practice in risk parameter estimation is both necessary and desirable. This view is consistent with the supervisors' own concerns regarding diversity of practice.[2] At the same time, however, there is a natural tendency for supervisors to engage in the sort of "cumulative conservatism" that was evidenced in earlier versions of the Basel II Framework.[3] Such conservatism, for its own sake, will tend to reduce diversity of practice – thereby reducing innovation in risk measurement. We appreciate supervisors' desires to avoid this result, and to that end we offer several suggestions concerning the benchmarking and credit risk analytics that supervisors might employ on the SNC data.

a. **Industry analysis**. The Proposal suggests that supervisors may be developing one or more indices of industrial "concentration" in wholesale portfolios. Such indices might reflect, for example, the manner in which some rating agencies measure industry-sector concentration. Or, new measures, such as variations of Herfindahl indices, may be developed utilizing the new 6-digit NAICS codes called for in the Proposal. Such *ad hoc* measures of concentration should be used with caution and may not be as accurate in estimating tail-thickness as internal estimates of pair-wise AVCs (where such AVCs explicitly take account of factors such as industrial classification, obligor size, etc.).

b. **Consistent application of benchmarks**. It would be natural for SNC examiners to compare the PDs a reporting bank assigns to each credit with, say, the median PDs for those credits. A reporting bank that habitually estimates lower PDs than its peers might be asked to justify these low estimates. This is an appropriate use of the new SNC database and a reasonable way for examiners to begin the dialogue with regard to Basel risk parameter estimation at each institution. At the same time, it would be appropriate for examiners to question a bank whose PDs are habitually <u>higher</u> than the PDs estimated by its peer banks. If, say, innovative ways of estimating PDs are evolving – evolving in a manner that suggest generally lower PDs – the examination process has been and should continue to be part of the process of achieving dissemination of such best practices, no matter the direction of the effect.

c. **Transparency**. As the SNC process evolves, benchmarking data will be fed back to the reporting banks. To the extent such feedback involves *analysis* by supervisors (rather than the simple compilation of results by, say, rating category or industrial sector), the method of analysis and the economic theory behind the analysis should be made very clear to the industry. Such clarity has been a hallmark of the Basel II evolutionary process and will enable an ongoing dialogue, which in turn will foster best practices both by the banks and by their supervisors.

IV. Feedback issues and confidentiality.

We agree with the thrust of the Proposal, that certain SNC data given back to the reporting banks would be helpful in honing internal practices, and such feedback would help meet the benchmarking requirements of Basel II. If the SNC modernization process focuses fairly narrowly on the Basel risk parameter estimation process, this suggests that data on Basel PDs, LGDs, and EADs will constitute the main bulk of the feedback. Other data – such as industrial concentration measures – will probably be less useful for internal risk measurement purposes, but the distribution of such data would help foster an appropriate dialogue with supervisors regarding the potential uses of the data. For all such data-feedback a key concern is balancing the usefulness of the feedback with the desire for each reporting bank to maintain the confidentiality of its own data. To protect against disclosure of proprietary information, we have several suggestions:

a. Limit the distribution of loan-level information to only the Expanded Reporters, as suggested in the Proposal.

b. Use median loan-level PDs, LGDs, and EADs rather than averages, which can be distorted by an outlier. Do not distribute quartile information.

c. Do not distribute loan-level median information when there are 4 or fewer Expanded Reporters, including the agent(s), participating in the credit.

By distributing feedback information in this fashion, supervisors would minimize the chances that loan-level or portfolio composition data would fall into the wrong hands.

We appreciate this opportunity to comment on the SNC Modernization Proposal, and we look forward to working closely with the supervisory agencies to meet our common objectives of efficiency and accuracy in the collection of SNC data.

Staff participating in preparation or review of this paper:

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

HSBC/North America Holdings: John Zeller, Executive Vice President, Credit Risk Management; David Coleman, Senior Vice President, Credit Risk Management; David Morin, Senior Vice President, Credit Risk Management; John Roesgen, Senior Vice President, Finance; Stephen Mongulla, Director, Credit Policy

JPMorganChase & Co: Adam Gilbert, Managing Director; Michel Araten, Managing Director

KeyCorp: Ashish K. Dev, Executive Vice President, Enterprise-Wide Risk Solutions; Michael Pykhtin, Vice President, Risk Management

PNC Financial Services Group: Shaheen Dil, Senior Vice President & Director, Risk Analytics; Terry Jewell, Senior Vice President & Manager, Quantitative Modeling Group; Thomas Bogdewic, Vice President, Portfolio Management

RBC Financial: Lyn McGowan, Senior Manager, Basel Accord Implementation; Chitra

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

State Street: Wendy Phillis-Lavoie, Basel II Project Leader; F. Andrew Beise, Basel II Credit Risk Team Leader; William H. Schomburg III, Director, Economic Capital; Norman J. Greenfeld, Director of Counterparty Review; Joseph J. Barry, Vice President, Legal & Industry Affairs

SunTrust: Kenneth J. Ferrara, Group Vice President; Jennie Raymond, Portfolio Analytics; David Fisher, Senior Vice President, Portfolio Risk

Union Bank of California: Paul C. Ross, Senior Vice President, Portfolio Risk Management; Desta G. Medhin-Huff, Vice President, Portfolio Risk Management

Wachovia: Gary Wilhite, Senior Vice President, Credit Risk Management; Ann Baker, Vice President, Credit Risk Review; David Gylfe, Vice President, Credit Risk Management.

Wells Fargo: Jouni Korhonen, Senior Vice President, Credit Risk Architecture

The Risk Management Association: Pamela Martin, Director, Regulatory Relations & Communications; Mark A. Zmiewski, Director, Strategic Learning & Research; Suzanne I. Wharton. Project Manager, Strategic Learning & Research

Mingo & Co.: John Mingo, Managing Director

[1] The Risk Management Association 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. The names of the institutions represented on the Capital Working Group, along with staff members contributing to the preparation of this response, are shown in an Appendix. Individual banking organizations that are members of the Group may be responding separately to the SNC Program Modernization, and may hold opinions regarding the SNC proposal that differ from those expressed in this paper.

[2] See p. 9 of the Proposal, “The Agencies realize that there are various methods used to evaluate risk. Consequently, multiple conclusions could be drawn from the same information, yet still arrive at a sound and consistent risk assessment.”

[3] See, for example, RMA, “Response to Basel’s Third Consultative Paper on the New Capital Accord,” July 2003.