Jeffrey P. Neubert
President and CEO

100 Broad Street
New York, NY 10004
tele 212.612.9203

jeffrey.neubert@theclearinghouse.org

THE CLEARING HOUSE
Advancing Payment Solutions Worldwide

June 29, 2005

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

Attention: Docket No. OP-1227

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

Attention: Comments/Legal ESS

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

Attention: Docket No. 05-08

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

Attention: No. 2005-14

Re: Interagency Proposal on the Classification of Commercial Credit Exposures

Ladies and Gentlemen:

The Clearing House Association L.L.C. ("The Clearing House"), an association of 11 major commercial banks,[1] appreciates the opportunity to comment on the Interagency Proposal on the Classification of Commercial Credit Exposures (the "Proposal"), recently

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

published by the Board of Governors of the Federal Reserve System (the "Board"), the Federal Deposit Insurance Corporation (the "FDIC"), the Office of the Comptroller of the Currency (the "OCC") and the Office of Thrift Supervision (the "OTS") (together, the "Agencies").[2]

Our comments on the Proposal outline common concerns and suggestions of The Clearing House member banks. In addition, several of our member banks have submitted, or will be submitting, individual comment letters to the Agencies.

A. *The Proposal is Premature.*

As a substantive matter, we support the Agencies' approach of replacing the current classification system for commercial credit exposures with a two-dimensional framework that considers both (i) the borrower's capacity to meet its debt obligations and (ii) facility characteristics that influence loss severity. We appreciate the Agencies' efforts to correlate ratings more closely to actual risk of loss and, more generally, to create a more finely calibrated and sophisticated rating approach. The overall concept of the proposal – if designed properly – should provide a more accurate and reliable assessment of the true risk in credit exposures. Further, a well-designed system should make the process of translating internal bank ratings to regulatory designations more transparent and consistent.

Our most important comment, however, relates to our belief that the Proposal is premature. The Clearing House member banks are in the process of implementing the internal ratings-based approach to computing regulatory capital for credit exposures in accordance with the *International Convergence of Capital Measurement and Capital Standards: A Revised Framework* ("Basel II"). Similar to the Proposal, the loan rating system required by Basel II is two-tiered and takes into account both the probability of borrower default and facility characteristics that influence loss severity.

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[2] Interagency Proposal on the Classification of Commercial Credit Exposures, 70 Fed. Reg. 15681 (March 28, 2005).

If the Agencies choose to adopt now the classification system described in the Proposal, member banks will be essentially required to implement two different two-tiered rating systems. The inconsistencies that exist between the requirements in Basel II and those in the Proposal will result in general confusion and inefficiencies for all banks that are required to comply with Basel II, as well as the "opt-in" banks.[3] Several of these inconsistencies are mentioned in the following sections.

B. Definition of Default

The Proposal provides that a "Default" rating is geared to "management [having] placed one or more of the borrower's facility on non-accrual or recognized a full or partial charge-off" as those terms are further defined. 70 Fed. Reg. at 15685. The definition of "Default" in Basel II for commercial loans continues to evolve; most recently, the Basel II definition was modified by the Quantitative Impact Study (QIS-4) conducted in connection with Basel II. Because it is essential that consistent terminology be used in this important area, we suggest that it is premature to adopt the Proposal, including its definition of "Default", until that consistency can be assured.

C. Non-Accrual Loans

The Proposal dictates that all non-accrual loans will be moved into the "Default" category (the most negative borrower rating under the Proposal). 70 Fed. Reg. at 15684. This would represent a significant departure from current practice and cause a significant increase in the percentage of the banks' classified portfolios that are accorded the most negative borrower rating. Banks currently rate many non-accrual loans "Substandard" (the second most negative borrower rating under the current definitions) rather than "Doubtful" (the most negative

[3] We recognize that the Proposal suggests that banks "may incorporate this framework into their internal risk rating systems" or vice versa (70 Fed. Reg. at 15683), but it is not clear how the differences would be resolved.

borrower rating under the current definitions). We believe that this change will have significant, and inappropriate, implications for banks' loan loss reserves.

D. *Borrower Rating Definitions*

The proposed Borrower Rating definitions of "Marginal", "Weak", and "Default" are substantially similar to the current definitions of "Special Mention", "Substandard", and "Doubtful". We see no material benefit to changing the titles of these categories, and such a change could create the risk of both internal and external confusion. We suggest the Agencies keep the current titles, and focus their attention on (i) matching the Borrower Rating definitions with the Basel II definitions, which correspond to the borrower's probability of default, and (ii) creating numerical benchmark ranges of "default probability" for the Borrower Rating definitions, much like the Facility Ratings. If benchmark ranges of "default probability" are not assigned to the Borrower Rating definitions, we are concerned that banks will inconsistently apply the qualitative definitions outlined in the Proposal.

If the proposed change is made in the terminology, we urge reconsideration of the term "Default." Although the Proposal explicitly states that the use of this term does not connote an actual default under the loan terms, there is a risk of confusion. We believe "Doubtful" remains a superior term; an alternative might be "Poor".

E. *Facility Ratings*

The Proposal states that Facility Ratings are required only for those borrowers rated "Default". For borrowers not rated "Default", banks have the option of assigning Facility Ratings. This contrasts with one of the basic requirements of Basel II, for larger banks as well as "opt-in" banks, to examine loss given default in each situation, whether or not a "default" has occurred.

F. *Loss Severity Levels*

We have a number of serious concerns with the proposed Loss Severity Levels. First, financial institutions may be reluctant to classify any of their facilities "Remote Risk of Loss" if it requires a 0% factor, because they believe there is always a chance of loss, albeit small, particularly on a loan with a Default rating.

Second, the last two categories, Moderate and High, do not provide sufficient granularity. As proposed, the breadth of the various baskets (5%-30% and greater than 30%) is likely to result in one of the dangers the Basel II requirements are meant to prevent -- facilities with widely varied loss given default estimates falling within the same loss severity level.

Third, requiring a full charge-off of exposures rated High Loss Severity seems too stringent when the hurdle is as low as 30%.

Fourth, even a 5% hurdle for Low Loss Severity may restrict the practical ability of financial institutions to use that category.

We recommend that financial institutions with Basel-compliant portfolio tracking systems have the option of using the loss severity levels established under their Basel-compliant systems. Alternatively, if specific percentages are retained, we recommend that (i) "remote" be defined in terms of 0%-5%; (ii) thereafter there be 5% (or at most 10%) increments to ensure granularity in the baskets; and (iii) a full charge-off not be required until the anticipated loss is 40%-50% or greater.

G. *Specialized Lending Activities*

The Proposal states that "agencies will need to review the existing classification guidance for specialized lending activities, such as commercial real estate lending, to reflect the proposed rating framework." 70 Fed. Reg. at 15683. Before the Proposal is implemented, we recommend that the treatment of specialized lending activities be finalized and generally matched to those found in Basel II. Otherwise, the rating system will fail to capture actual risk and various banks will be treated either too harshly (and unfairly) or too leniently.

H. *Guarantees and Other Support*

The Proposal does not provide sufficient specificity regarding the treatment of factors that mitigate loss, such as collateral and guarantees, for rating assignment. 70 Fed. Reg. at 15683-15684. The Agencies clearly intend to provide some guidance on this matter in the Proposal: "When a facility is unconditionally guaranteed, the guarantor's rating can be substituted for that of the borrower to determine whether a facility should be criticized or classified." 70 Fed. Reg. at 15685. We recommend that the Agencies elaborate on this statement and specify how limited guarantees and other forms of support may be treated for rating assignment.

I. *Asset Based Lending*

We are particularly concerned by the Proposal's treatment of asset-based lending. In view of the wide variety of asset classes that can serve as collateral and the changes in value over time, we believe that a uniform, or "one-size fits all", approach (except for agricultural lending) fails to evaluate credit risk. In particular, we are concerned that a "remote risk of loss" category can be applied to only certain limited types of asset collateralization. The answer is not to discount severely and uniformly the value of asset-based lending, but to adopt the Basel II flexible approach. As the "Background Information" section of the Proposal indicates, one flaw in the current system is its focus on borrower weakness, "without specifying how factors that mitigate the loss, such as collateral and guarantees, should be considered." 70 Fed. Reg. at 15682.

We also believe that the Proposal generally undervalues collateral and, specifically, that a bank should be able to rate a qualifying Marginal / Low Loss Severity ABL exposure as Pass.

J. *Undrawn Commitments*

Undrawn commitments in the form of lines of credit with borrowing bases or other contractual restrictions on draws can be excluded from the calculation of a bank's criticized

and classified assets "only if it is management's intent and practice to exert the institution's contractual right". 70 Fed. Reg. at 15685. In view of the vagueness of the word "practice", we recommend its deletion. This term is also unnecessary, because it would be difficult for an institution to maintain that its intent is to exercise its rights if it invariably fails to do so.

K. *Recovery Rates*

The Proposal provides that "[s]upervisors will focus on estimates where institution management has estimated recovery rates in excess of a loan's collateral value." Id. We do not understand why estimates are more suspect in the case of such loans than recovery estimates where there is no collateral.

L. *"Eligible Collateral"*

We believe that "eligible" collateral for the remote risk category should be broader than the specific list contained in the Proposal. 70 Fed. Reg. at 15684. The use of the word "includes" may connote that flexibility, but any final release should provide clarification supporting a broader reading.

M. *Remote Risk of Loss on Collateralized Loans*

We believe that a bank should have the flexibility to determine that a collateralized loan represents a remote risk of loss even if one or more of the criteria listed in the Proposal (70 Fed. Reg. 15685) is not met. The criteria would be better phrased as guidelines rather than requirements. In any event, we believe that the 90-day liquidation expectation is unrealistic; we recommend 180 days.

N. *Grading Inconsistencies*

We believe that there are some inconsistencies in grade treatment resulting from the mapping of asset quality ratings, in conjunction with the guidelines for asset write-downs. For example, an exposure with a Marginal borrower rating and a Low Loss Severity facility rating would be rated Criticized. An exposure with a Default borrower rating and a Low Loss

Severity facility rating could have up to 5% of the exposure considered "Loss", with that amount written off. The remaining 95% of the exposure could then be rated "Pass". Additionally, it appears counterintuitive that a "Default" (i.e., non-accrual) borrower could obtain a Pass rating, inferring a better risk profile than a fully performing Marginal rated borrower, simply by a write-off of 5% of exposure.

O. *Miscellaneous*

The Proposal suggests that an institution may take a write-down on a loan and then upgrade the loan to a higher category. 70 Fed. Reg. at 15684. It is unclear how this approach would relate to the non-accrual status of the remaining portion of the loan.

The Proposal states that the "framework contains additional applications of facility ratings; however, institutions may choose not to use them". 70 Fed. Reg. at 15683. We are not sure what level of flexibility is being provided.

In order to qualify for remote risk treatment for asset-based lending, the collateral must be under the bank's "control". 70 Fed. Reg. at 15685. We believe that this term needs definition because a bank would rarely have actual physical possession of collateral. We assume that a prior perfected security interest (presumably perfected in the manner prescribed by the Uniform Commercial Code) constitutes "control" for the these purposes.

Certain areas could use greater clarity including how structural improvements (not just cash or livestock security) to a credit are considered in the facility risk ratings; how structural improvements allow for the movement from a classification status; what is expected in order to meet the 60-day requirement for valuing collateral; and what is done when there is no actual obligor rating.

Examples 3, 4 and 5 (70 Fed. Reg. 15687) are confusing with respect to use of remote risk of loss concept on defaulted loans, treatment of defaulted loans with large loan to value shortfalls on collateral, and assigning loss severity estimates based on pool concepts which

would conflict with the approach required under FAS 114 accounting rules for large nonaccrual loans.

To ensure clarity, the Proposal should include the ability, when appropriate, to assign equivalent credit ratings to multiple exposures within a lending relationship when those exposures are cross-collateralized and the loan documents contain cross default language.

The "cash dominion" requirement should be defined in terms of "the institution has either full cash dominion or loan-related documents grant the institution the *right* to cash dominion".

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

Sincerely,