November 3, 2003

Office of the Comptroller of the Currency
250 E Street, S.W.
Public Information Room, Mailstop 1-5
Washington, D.C. 20219

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

Mr. Robert E. Feldman, Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Dear Ms. Johnson and Mr. Feldman,

The New York State Banking Department (the Department) welcomes the opportunity to comment on the Federal Agencies' Advance Notice of Proposed Rulemaking, "Risk-Based Capital Guidelines; Implementation of the New Basel Capital Accord." The Department has followed the development of the New Accord and, as supervisor of community banks as well as LCBOs and foreign banking organizations, is concerned with the possible impact of these proposed capital guidelines.

Although the New Accord has evolved over years of international discussion and compromise, the Department feels that it is still too complex. A simpler set of regulations would be more successfully implemented and reviewed, in the Department's opinion. The myriad details of the New Basel Capital Accord impose a heavy burden on banks, and on their supervisors. A simpler accord would be more risk sensitive than current requirements in its weighting of assets, but neither so prescriptive nor so demanding of verification by supervisors as the New Accord.

However, Basel II's advanced approaches for credit risk and operational risk form the basis of the Agencies' proposal and are under consideration for implementation in the U.S. The Department's comments are organized around several major themes:

- *A bifurcated approach reflects the reality of the U.S. banking market.*
- *Participation in the New Accord should be optional for all banks.*
- *It is important to retain the PCA leverage ratio requirements.*
- *Bank supervisors should monitor the implementation of the A-IRB approach to minimize competitive disadvantages for general banks, and to maintain availability of credit.*

- *Banks should be allowed to take into account correlation and diversification effects in calculating regulatory capital.*

- *Supervisors should emphasize examiner review and establishment of a control culture rather than relying on sophisticated capital models.*

- *Programs for supervisory review of AMA op risk systems should concentrate on corporate governance and controls.*

- *Specific elements of the proposal merit revision.*

The Department is appreciative of the efforts of U.S. bank regulators in preparing implementation policies and guidelines for maintaining the safety and soundness of U.S. banks once the New Basel Capital Accord is adopted. Implementing Basel II will be a highly complex operation both for banks following the Advanced approaches and their supervisors. The Department hopes that its comments will assist the Agencies in this process.

I. A bifurcated approach reflects the reality of the U.S. banking market.

The Department congratulates the Agencies on proposing the bifurcated approach as recommended in the Department's April 10, 2000, and May 31, 2001, comment letters to the Basel Committee on Banking Supervision and the Board of Governors of the Federal Reserve System. Bifurcation recognizes the reality that the business conducted by thousands of community and regional banks is quite different from that conducted by LCBOs. Consequently, not all banks should be compelled to follow standards deemed necessary for LCBOs.

The Department does not expect a bifurcated approach to lead to an increase in industry consolidation, as mergers and acquisitions should continue to be based on factors such as strategic outlooks, market share, new products, economies of scale, and senior management succession plans rather than on marginal changes in capital requirements. While capital enhances safety and soundness, factors such as senior management competence and integrity, core profitability, environmental changes, internal controls, and reputation are equally or more relevant.

Capital ratios as well as business plans tend to be different at LCBOs and smaller banks. Compared to community and regional banks, LCBOs tend to have capital ratios that are closer to the well-capitalized minimums (see Table 1). All five of the New York State banks with assets over $45 billion have leverage ratios between 5.4% and 6.2%, while the range for all banks is from 5.3% to 52%.[1] (The leverage ratio is more constraining than the risk-based capital ratios.) Thus, bifurcation seems to address the concern of LCBOs to manage their capital ratios, while acknowledging that most community and regional banks are comfortable with much higher than required capital ratios.

---

[1] Data is drawn from "Call Reports" for New York State headquartered banks as of 6/30/03, http://www.fdic.gov

However, the situation for large regional banks may be somewhat different: the 12 New York banks with assets between $5 billion and $45 billion tend to have higher capital ratios than the largest banks, but may be feeling market pressure to manage these ratios. For these institutions, opting in to the A-IRB approach could make it possible to maintain the same risk-based capital ratios while lowering their leverage ratio close to 5%. As IRB systems and software become more developed, opting in may make more sense for these banks, especially since sophisticated credit risk modeling systems also allow more risk-sensitive pricing.

Table 1. Capital Ratios at 207 New York State Banks

	Tier 1 leverage ratio	Tier 1 risk-based capital ratio	Total risk-based capital ratio
Minimum requirement for well-capitalized banks	5%	6%	10%
Number of banks with ratios ≥ 2% above minimums	169 / 207 (≥ 7%)	204 / 207 (≥ 8%)	177 / 207 (≥ 12%)
Top 5 banks in assets (average)	6.0%	7.8%	11.5%
NYS banks: average ratio	10.5%	20.8%	21.9%
NYS banks: minimum ratio	5.3%	6.5%	10.1%
NYS banks: maximum ratio	51.7%	168.4%	168.4%

II. Participation in the New Accord should be optional for all banks.

Banks should be allowed to opt in if they meet the same criteria required of those institutions mandated to follow A-IRB. The oft-repeated line, as stated on page 13 of the ANPR, is that the advanced framework "is more risk sensitive," but voluminous details do not necessarily result in more appropriate capital requirements. The initial Basel Capital Accord took an admittedly simplistic approach, but this had the advantage of meeting the basic objective of establishing minimal capital requirements while not trying to address and quantify every situation. To help alleviate concerns that the New Accord is overly complicated, best practices regarding risk management should be handled as much as possible separately from capital adequacy guidance.

Based on the current proposal, the Department suggests that no U.S. bank be mandated to follow the New Accord. Banks that adopt the New Accord should be allowed to return subsequently to existing guidance. Current regulatory capital requirements – while not particularly risk-sensitive – have proven to be useful in giving regulators the comfort of a minimal capital cushion, and thereby provide a well-established alternative. All U.S. banks should be allowed to perform an unbiased cost-benefit study to see if the expected burdens of complying with the New Accord with the leverage ratio still in place justify the significant corresponding expense. Regulators could use the number of banks that choose to opt-out as a key indicator in determining whether improvements should be made to the New Accord. The ability to freely opt-in or opt-out will also enhance Pillar 3 by letting market discipline have a stronger say in how regulatory capital is calculated.

The Department asserts that retaining the leverage ratio for all banks and conducting substantial on-site examinations are essential to the success of the bifurcated approach. On matching regulatory capital to economic risks, page 7 notes the Agencies' intention "to move to a framework where regulatory capital is more closely aligned to economic capital." While the Department appreciates that the Agencies have not taken this path, it does not believe this is a worthwhile goal. While the underlying objective of economic capital is to maximize profits, regulatory capital must remain focused on safety and soundness. Consequently, there will likely always be the need for regulators to go an extra step beyond what banks believe to be sufficient capital.

Nonetheless, the Department is concerned with some of the consequences of bifurcated regulation. The proposed regulations for Advanced IRB banks will be applied to loans of the type held by almost all banks, and capital treatment will depend on risk management techniques at large banks, not on a uniform measure of riskiness of particular loans. Finally, these regulations do not confer any capital benefits for increased risk sensitivity at general banks (those that are neither mandatory banks nor choose to opt in).

For additional suggestions to improve the New Accord, see the Department's prior comment letters dated April 10, 2000, May 31, 2001, November 1, 2001, and July 31, 2003, which are also available on the Department's web site at www.banking.state.ny.us (click on "Selected Regulations" and go to "Department Comment Letters").

III. It is important to retain the PCA leverage ratio requirements.

The Department commends the Agencies for retaining the leverage ratio, and strongly encourages the Agencies to continue this policy. While the Department acknowledges that U.S.-based LCBOs want the leverage ratio dropped to provide parity with international competitors, safety and soundness is best served by preserving the leverage ratio for all banks. As a key feature of the FDIC Improvement Act of 1991, the leverage ratio has served U.S. taxpayers well in bank failures over the past decade. Maintaining the leverage ratio as a unique additional U.S. requirement also supports the Agencies' decision to not apply the New Accord to all U.S. banks. Also, the competitive implications for community and mid-size regional banks should be less significant as long as the leverage ratio remains in effect.

IV. Bank regulators should monitor the implementation of the A-IRB approach to minimize competitive disadvantages for general banks, and to foster availability of credit.

Any aspect of regulatory capital requirements that does not apply to all banks contains the potential for competitive inequalities. While persuasive quantitative proof of competitive harm may not exist, the Agencies should not conclude that capital requirements do not impact competitiveness. Instead, regulators must monitor the effects of regulatory capital requirements during the implementation period, and propose changes in requirements for general banks if competitive disadvantages become material. In addition, the risk weight functions should be re-calibrated if the availability of credit is impacted negatively by the proposed requirements.

An incentive for a general bank to opt in to the A-IRB approach might come from the perception that general banks are "unsophisticated" or have a lower return on equity. The Department welcomes the statement by rating agency Standard & Poor's that they will review the capital held at A-IRB banks closely for adequacy. On August 26, 2003, Clifford Griep, Executive Vice President and Chief Credit Officer of S&P, stated that banks could be downgraded if they reduce their risk capital provisions on the basis of the

Basel II accord using calculation methodologies with which S&P doesn't agree. This would appear to be directly aimed at Basel II's approach to mortgages and consumer lending. However, banks may still feel pressure to invest in sophisticated risk management systems and opt in to the Advanced approaches.

Since the possibility of lower capital requirements is an obvious incentive to opt in, a key question is whether general banks would experience lower capital requirements after adopting the A-IRB approach. These banks' retail portfolios, in particular residential real estate, would most likely command much lower risk weights than the current 50%. It is harder to determine what the risk weight for the banks' other loans would be, since most of the non-LCBO banks have few loans to publicly rated counterparties, and, therefore, can't rely on PDs based on agency ratings or equity prices.

To investigate this question, the Department developed test portfolios of middle market loans. After simulating different PD levels and LGD levels for the loans in the portfolio and calculating required capital according to the wholesale corporate formula, the Department found that the required capital charge was on average about 5.5% for the test portfolios. The Department developed the portfolios around SIC (Standard Industrial Classification) codes, and consulted banks for a breakdown of their loan portfolios by SIC code. The Department then used RiskCalc PDs as reported by RMA for companies in the industry groups represented by these codes (see Appendix A for a description of the test results).[2]

On October 13, the Basel Committee reported a revision to the proposed accord: instead of a risk weight function that calculated the capital requirement to include expected loss and unexpected loss, the revised risk weight function will cover unexpected loss alone. (The proposed treatment for expected loss would involve measuring the loan loss reserve against expected loss and then subtracting any shortfall from capital and counting excess towards capital.) When this proposed revision was estimated by subtracting expected loss for each SIC category, then the average capital charge over 10,000 simulations for the test portfolios is close to 5%. It is important to note, however, that a limitation to using the RMA data is that PDs for finance, insurance, and real estate industries are not reported.

According to the third Quantitative Impact Study carried out by the Basel Committee, LCBOs would have lower capital charges on average for their corporate loan portfolios. Results of the Department's tests suggest that middle-market loan portfolios would also have lower capital requirements on average. The Department recommends that the Federal Reserve include questions covering middle-market and small business loans on the Senior Loan Officer Opinion Survey, and that other regulators, federal and state, survey their supervised institutions for possible competitive effects of the A-IRB regulations.

The Department is also concerned with the effect the proposed regulations may have on the availability of loans. Craig Furfine, in his paper on the response of U.S. banks to changes in capital requirements,[3] reported that the level of C&I lending decreased after

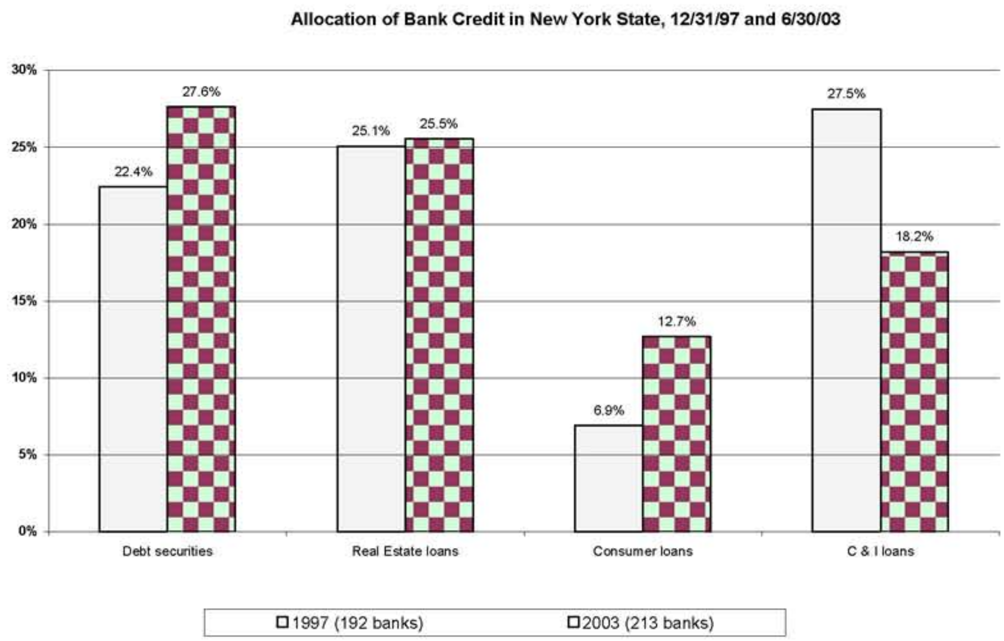
---

2 "Annual Statement Studies, 2002," The Risk Management Association

3 Craig Furfine, "Evidence on the Response of US Banks to Changes in Capital Requirements, BIS Working Papers, No. 88 – June 2000, Bank for International Settlements, http://www.bis.org/publ/work.htm

the adoption of the 1988 Capital Accord. As we approach adoption of the New Capital Accord, it is important to consider what effect this accord could have on the make-up of bank portfolios. Furfine found evidence that U.S. banks changed their portfolios in response to the 1988 Accord. He reported that in 1989, government securities made up 15% of total bank credit; in 1994, this share had risen to close to 25%. Over the same period, the share of total bank credit in C&I loans decreased from 22.5% to about 16%.

The Department examined the trend in bank portfolio make-up since 1997, in order to discuss the possible effects of the proposed regulations. In New York State, the share of bank credit in C&I loans was higher on 12/31/97 than the 1994 national figure reported by Furfine, but has decreased every year but one since then. As can be seen from the chart below, the share of bank credit in debt securities and consumer loans increased, while the share in residential real estate stayed much the same and C&I loans decreased. These changes are undoubtedly the result of complicated market factors, including business cycle effects: the years 1997 – 2003 span a period of national expansion and overall loan growth[4] (1997 – 2000) and a recession (2001).



Second quarter figures for the years 1997 through 1993 show over 90% of all C&I loans in New York State banks held by the six largest banks in asset size. Considering their enormous market share, it is important to look for any change in the allocation of C&I lending at these banks; Table 2 below shows that allocation at the top six banks has decreased.

[4] "Quarterly Summary of Banking Statistics," Banking Research, Federal Reserve Bank of New York, October 24, 2003

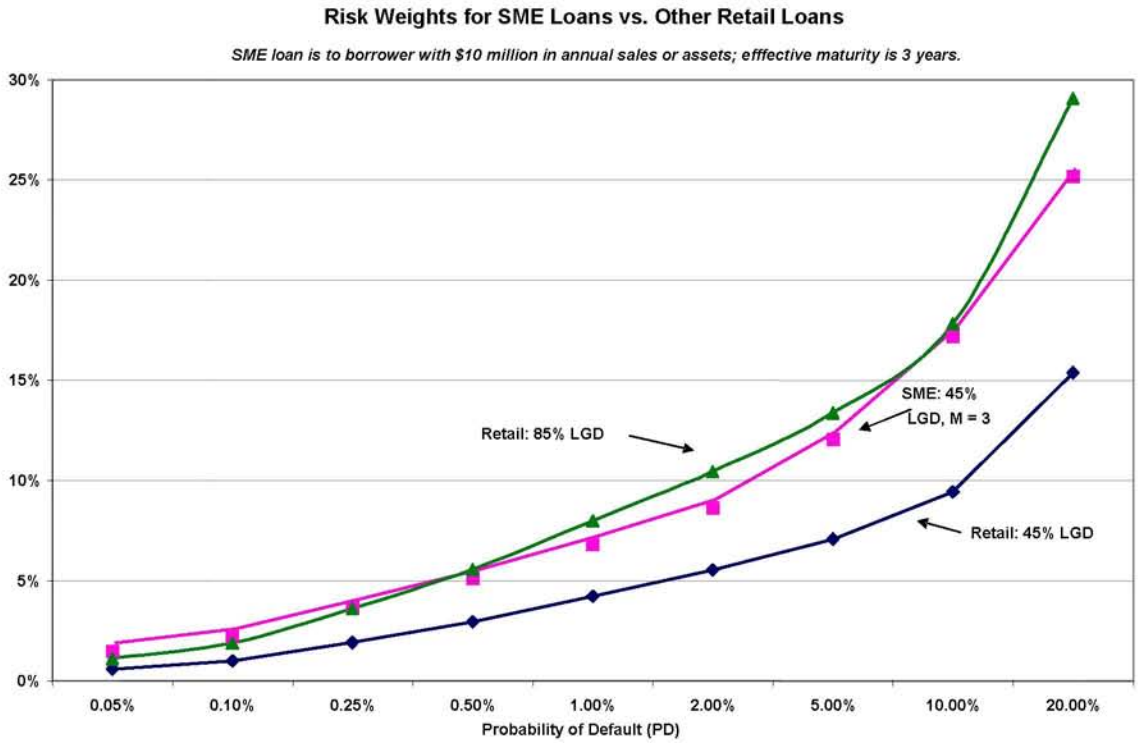
Table 2. C&I Loans in New York State Banks, 1997 and 2003

	12/31/97	6/30/03
Percent held by top 6 banks in asset size	92%	91%
Share of bank credit at top 6 banks in C&I loans	31%	21%

Economists have expressed concern that implementation of the New Basel Accord might aggravate business cycle effects: that the new capital requirements would be lower in times of expansion and higher in downturns, thus possibly exacerbating “credit crunches.” An additional concern is that the proposed capital requirements could exaggerate a shift in lending to consumer loans that would impact the availability of credit for businesses. The Department recommends that the Agencies monitor loan demand and the availability of credit during the implementation period to ensure that the proposed regulations do not provide a disincentive to engage in C&I lending.

The calibration of the various risk weight functions in the New Accord is crucial. One area where calibration may need adjustment is in the relative capital benefit provided for pooled small business loans treated under the “other retail” risk weighting as opposed to loans treated as SME exposures under the corporate risk weighting. Comparing loans of $1 million and less to small businesses of varying sizes (from $5 million to $50 million in annual sales or total assets) it appears that unless the loans are short term, the risk weights for the same PD and LGD were lower for retail exposures. This is due in part to the fact that, while there is a maturity adjustment for wholesale loans, maturity is not a factor in the risk weight for retail loans.

The chart below shows the risk weights for “other retail” loans with 45% and 85% LGDs compared to a wholesale loan at 45% LGD to an SME borrower with $10 million in annual sales. The ANPR makes no assumptions about LGD estimates for “other retail” exposures, and in fact, the table showing selected risk weights for the “other retail” portfolio uses 25%, 50%, and 75% LGDs. It appears that the “other retail” risk weights were calibrated under the assumption that LGDs would typically be over 80%. The Department is concerned that banks will perceive an advantage in offering other retail loans under $1 million over wholesale loans to small businesses, and that portfolios with lower historical LGDs will be treated under the retail category. This could contribute to the trend away from C&I lending; one possible effect of this trend could be a significant change in the pricing for C&I loans.



V. Banks should be allowed to take into account correlation and diversification effects in calculating regulatory capital.

The regulatory capital model for A-IRB exposures is a single-factor model that does not recognize diversification effects and uses fixed asset correlation formulas in particular portfolios. In contrast, banks' portfolio models take varying correlations and diversification effects into account. The Department would allow banks to include correlation and diversification effects in their calculation of regulatory capital as long as the PCA leverage ratio requirement is in effect, portfolio models are reviewed by examiners, and regulators can require more capital if the model outputs are not considered adequate.

By allowing banks to use their own models, supervisory review will be more efficient, as separate regulatory capital reviews will not have to be carried out in addition to internal economic capital reviews. Also, banks will not have to devote resources to calculating the A-IRB capital charge, when they are unlikely to use the results internally. Allowing use of internal models, subject to review, will avoid double work by both regulators and bankers and still allow a starting point to determine minimum regulatory capital

The fundamental economic capital models have been shown to be similar with proper calibration, as modeling credit loss distributions is becoming more and more well-established. The significant variations between capital requirements will arise from differences in estimated or assumed parameter values; these will exist, in any case, under the A-IRB proposals. By specifying a common 99.9% confidence level and certain industry-wide assumptions, and reviewing bank-specific assumptions and parameter values, regulators can control significant variations in the results. Finally, the Department recommends that the 90% and 80% floors proposed for the A-IRB approach be applied to capital charges calculated from internal economic capital models.

The variations between banks will be initially challenging to supervisors. However, subsequent reviews will be easier given more familiarity with an internal model at a specific institution. The review over parameter estimations will still be necessary whether banks use A-IRB models or their own economic capital model.

VI. Supervisors should emphasize examiner review and establishment of a control culture at Advanced IRB banks.

The Department affirms the necessity of keeping up to date with bank practice, and recommends that model review and testing are a vital part of bank supervision. The Department also recognizes, however, that the judgmental aspects of credit risk modeling must be subject to supervisory oversight as well. The Department is concerned that the emphasis on statistical estimates based on historical data can give a false sense of soundness unless counterbalanced by the proper control culture.

Controls are essential to a sound implementation of Advanced IRB systems. These systems comprise specialized technical models and extensive databases, and require finer degrees of discrimination between borrowers than have been made in the past. The Department found a lack of adequate controls and policies and procedures at some banks during the recently completed examination cycle. A continuing concern will be whether adequate controls are and will remain in place to support the A-IRB system. A review of the examination exceptions that the Department found can provide pointers to areas that will be of particular importance once A-IRB systems are implemented.

The Department tracked exceptions in the areas of credit risk, market risk, and operational risk over the recently completed 2002 exam cycle, and found that operational risk exceptions accounted for 47% of all examination exceptions observed, as compared to 18% and 19% for credit and market risks, respectively. Within operational risk, weaknesses in audit account for nearly 25% of the exceptions observed, with inadequate audit scope and deficient audit reporting and issue tracking the most cited exceptions. From an internal control perspective, the most cited deficiencies are in the areas of inadequate policies and procedures and corporate governance. Corporate governance exceptions highlighted inadequate management oversight and documentation of the decision-making process, and in certain cases the failure to provide an overall organizational “control consciousness.”

The most cited examination exceptions across all banks in credit risk continue to be inadequate policies and procedures, inadequate credit administration, and corporate governance. Corporate governance issues were related to management oversight and the credit committee decision-making process. For market risk, the most cited examination exceptions are inadequate policies and procedures, corporate governance, and model deficiencies. Corporate governance again related to general management oversight and committee service decision-making process. Although market models are considered mature, model deficiencies have been noted particularly in the areas of stress-testing and back-testing.

The Department emphasizes that supervisory attention to weaknesses in policies and procedures, management oversight, and decision-making processes is crucial for safe and sound implementation of the A-IRB approach.

VII. Supervisors should develop programs for review of AMA op risk systems that concentrate on corporate governance and controls.

The Department is encouraged by the progress made in developing operational risk programs over the last few years. However, it is important to remember that estimates of operational risk parameters still rely to a great extent on judgment, as extreme operational risk events are rare and difficult to model. Further, a commitment to establishing proper controls and oversight is basic to any operational risk program. Finally, it is probable that AMA models will vary significantly from bank to bank, because of differences in modeling approach and judgmental appraisal of operational risks. For these reasons, the Department suggests that supervisory review of AMA banks should be emphasized over attention to statistical models, and that supervisors should establish "Pillar 2" programs for supervision of AMA banks. A program of this sort is applicable to all banks, from small community bank to large LCBO, and provides supervisors with a powerful tool for assessing risk at individual institutions as well as across them.

Supervisors should focus on corporate governance and ensure that an operational risk program includes all the necessary elements of a complete process: Objectives, Risk Assessment of Key Processes, Controls, and Action Plans. The process should become ingrained as part of the organization's overall "control consciousness."

Institutions should be encouraged to implement a system of operational risk management not only for the purposes of Basel II, but also for an overall value-added benefit that goes beyond meeting Basel II requirements. For instance, the process should improve operations in terms of efficiency. Greater efficiency means more flexibility in pricing, which could translate into a competitive advantage to attract customers as possible cost savings are passed on to the customer. Certain industry participants have already identified the need to merge Basel II requirements with Sarbanes-Oxley requirements as they have common elements: both are enterprise-wide, assess risks and the strengths of controls, monitor actions, require ongoing analysis and assessment, are COSO-based (Committee of Sponsoring Organization), and require Board and Executive oversight.

VIII. Specific elements of the proposal merit revision.

The Department's responses to specific questions posed by the Agencies are presented below. Page numbers refer to the location of the questions in the ANPR.

Application of the Advanced Approaches in the United States (p.16)

The Department has comments on three related issues on page 16:

- An institution that drops below both threshold levels should be permitted to opt-out. To indefinitely hold such banks to their initial status is unfair in comparison to other banks also just below either threshold.

- The Agencies should elaborate on what their "annual test" would be for assessing banking organizations in reference to the threshold levels. Otherwise this may be considered an arbitrary moving target.

- The Agencies should define what is meant by "well in advance" as to when opt-in banks must notify their primary supervisors. Regulators should be careful to avoid the perception that the most advanced capital methods are reserved only for a select few.

The Agencies seek comment on whether changes should be made to the existing general risk-based capital rules to enhance their risk-sensitivity or to reflect changes in the business lines or activities of banking organizations without imposing undue regulatory burden or complication. In particular, the Agencies seek comment on whether any changes to the general risk-based capital rules are necessary or warranted to address any competitive equity concerns associated with the bifurcated framework. (p.18)

The long term trend in the U.S. has been the consolidation of banks and the consolidation of consumer credit card and mortgage loans into fewer hands. Unless such loans require the same level of capital for a given level of risk at both A-IRB and general banks, the New Accord will add to this trend. Implementation of the New Accord in the U.S. is clearly an economically significant regulatory action and appropriate economic analysis should be required. In the last recession and the current expansion, money center, regional, and community banks have all demonstrated strong credit risk management. As noted above, the Department favors permitting any bank that meets Advanced approach requirements to opt in; the Department also recommends that the Agencies monitor the implementation of the A-IRB approach to minimize competitive effects for general banks.

The Department would await implementation of the New Accord to determine what, if any, aspects work best before incorporating further changes to the existing capital adequacy requirements. The greatest proof of whether changes need to be made to reduce competitive inequalities would be an unexpectedly large number of banks requesting to opt-in. The Department suggests that adoption of the Advanced approach could lead to reductions in the level of capital, but that retaining the leverage ratio should minimize the number of banks that reduce their regulatory capital. The legitimate concerns about competitive effects also lead the Department to reiterate the necessity of retaining the leverage ratio.

The Federal Reserve specifically seeks comment on the appropriate regulatory capital treatment for investments by bank holding companies in insurance underwriting subsidiaries as well as other non-bank subsidiaries that are subject to minimum regulatory capital requirements. (p.19)

While it is true that organizations and managers can make capital fungible across banks and insurance companies, often these practices would not be allowed if specific industry regulator approval was required.

Also, the liabilities between these two industries are significantly different in terms of maturity and volatility and the current ability to measure interest rate risk is imprecise. Therefore, the Department recommends that "excess" capital in one subsidiary should not be used to support the risk of another operating subsidiary. Until such time as bank regulators can reach specific agreement with insurance regulators on distribution of capital, organizations should be required to seek authorization from respective primary regulators for a special dividend and actually transfer capital to the operating entity experiencing a deficiency.

Should the A-IRB capital regime be based on a framework that allocates capital to EL plus UL, or to UL only? Which approach would more closely align the regulatory framework to the internal capital allocation techniques currently used by large institutions? If the framework were recalibrated solely to UL, modifications to the rest of the A-IRB framework would be required. The Agencies seek commenters' views on issues that would arise as a result of such recalibration. (p.25)

As noted above, the Basel Committee has proposed revisions to the New Capital Accord by which required capital formulas reflect unexpected loss alone, not unexpected loss plus expected loss. Under the revised proposal, banks will calculate the expected loss for their exposures and then compare expected loss with the sum of their general and specific reserves. Banks will be required to deduct any shortfall of loan allowances equally from Tier 1 and Tier 2 capital, and will be allowed to add excess loan allowances to Tier 2 capital, at the discretion of national supervisors, up to a limit of 20% of Tier 2 capital.

The Department favors a capital framework that allocates both for expected and unexpected losses, as capital is established as a cushion against all losses. If capital were required for both expected and unexpected loss, the Department would permit all general loan loss allowances to be allocated against capital requirements within Tier 2. This will provide better comparability in view of different accounting regimes. Such an approach should also help reduce the conflict between regulators concerned with safety and soundness and accounting standards-setters focused on the credibility of financial statements.

However, the Department recognizes that banks may hold reserves to cover the expected losses in their loan portfolios and use economic capital to cover the unexpected losses. If U.S. regulators adopt capital requirements that recognize unexpected loss alone, then the Department recommends that banks be required to deduct any shortfall of reserves compared to expected loss from Tier 1 and Tier 2 capital as in the Basel Committee revisions, but that no credit in Tier 2 capital be given for excess reserves. Further, the Department recommends that calibration issues in the A-IRB framework be reviewed if capital is required for unexpected loss alone.

The Agencies seek comment on the proposed definition of wholesale exposures and on the proposed inputs to the wholesale A-IRB capital formulas. What are views on the proposed definitions of default, PD, LGD, EAD, and M? Are there specific issues with the standards for the quantification of PD, LGD, EAD, or M on which the Agencies should focus? (p.29)

The proposal for Exposure at Default (EAD) for OTC derivative transactions should allow institutions to use their own internal models for counterparty exposure. This aligns regulatory capital better with internal risk management measures, since large institutions are not commonly using the regulatory "add-on" approach for their own internal risk management purposes. Allowing for this alternative would further encourage innovations in counterparty credit risk measurement.

The specification of 75% usage of undrawn lines under revolving purchase facilities appears very prescriptive. Institutions should be given the flexibility to determine, subject to supervisory review, the appropriate factor to apply to undrawn commitments for estimating EAD.

The Agencies invite comment on ways to deal with cyclicality in LGDs. How can risk sensitivity be achieved without creating undue burden? (p.34)

A number of research studies seem to support a correlation between default frequency and loss severity for specialized lending as well as wholesale commercial and retail fixed income obligations. Requiring institutions to maintain records of loss severity over at least one business cycle would be a simple approach to accumulating data that could support a 99.9% loss level. Loss data should be collected annually, and should be segmented by annual default frequency ranges.

The Agencies invite comment on the merits of the SSC approach in the United States. The Agencies also invite comment on the specific slotting criteria and associated risk weights that should be used by organizations to map their internal risk rating grades to supervisory rating grades if the SSC approach were to be adopted in the United States. (p.34)

The slotting criteria for IPCRE (income-producing commercial real estate) and HVCRE (high-volatility commercial real estate) specialized lending are identical even though it is acknowledged that they represent different degrees of credit risk. The four supervisory buckets of strong, good, satisfactory, and weak ignore the finding of the RMA Study of Best Practices that banks use as many rating grades for IPRE and HVCRE as they use for commercial and industrial lending. The RMA study banks likewise found that the weights assigned by supervisors to both IPCRE and HVCRE were higher than the median economic capital allocated by the survey banks.

In addition to the work by RMA, Toro Wheaton Research has found that PD and EL differ significantly by property type for a given cohort of loans. This would suggest that a more granular slotting approach would be more appropriate. A white paper, prepared by the Board of Governor's staff in June 2003, reports that asset correlations among different CRE sub-portfolios (*i.e.*, property types) represent different levels of risk.

Given the above, it would not be appropriate to introduce the supervisory slotting criteria until a more granular and quantitative model can be implemented. In the early 1990's U.S. banking supervisors established quantitative standards for commercial real estate lending. These standards were in effect during the recent recession; CRE lending did not produce the same level of problem loans for the industry then that it had in the previous recession.

In the Shared National Credit Exam only 3.0% of construction and real estate loan commitments were subject to criticism in 2000. This peaked at 7.5% in the 2002 exam and declined to 6.6% in the 2003 exam. This performance would suggest that more attention to underwriting such loans by both sophisticated and traditional banks produced strong credit quality that weathered the stress of recession. U.S. banking supervisors deserve credit for this as well.

The SNC results indicate that CRE has not been a significant problem for banks. The RMA study in fact reported that some banks found lower default rates for CRE loans than C&I loans in a given rating class. In July 2003, S&P released a study of commercial real estate loans housed in RMBS (residential mortgage-backed securities). S&P found that commercial mortgages performed solidly as a structured finance asset class. Loans originated in a weak economy tended to perform strongly and resolution losses of defaulted loans in a strong economy were likely to be moderate.

This would suggest that CRE should be treated no differently than C&I lending until better data can be gathered.

For the QRE sub-category of retail exposures only, the Agencies are seeking comment on whether or not to allow banking organizations to offset a portion of the A-IRB capital requirement relating to expected losses by demonstrating that their anticipated FMI for this sub-category is likely to more than sufficiently cover expected losses over the next year. (p. 42)

The Department strongly disagrees with permitting any future margin income to offset a portion of the A-IRB retail capital charge relating to EL. While bankers naturally anticipate that income will always exceed losses, this does not always occur. Further, the proposed approach may set the precedent to reduce other areas of capital by using easily manipulated amounts. Income should only be recognized as part of capital within retained earnings, which should ensure that earnings have actually occurred.

The Department notes that if the Agencies adopt the Basel Committee's revised treatment of unexpected and expected loss, the issue of using FMI as an offset of the capital charge will no longer be relevant.

The Agencies also seek comment on the competitive implications of allowing PMI recognition for banking organizations using the A-IRB approach but not allowing such recognition for general banks. In addition, the Agencies are interested in data on the relationship between PMI and LGD to help assess whether it may be appropriate to exclude residential mortgages covered by PMI from the proposed 10 percent LGD floor. The Agencies request comment on whether or the extent to which it might be appropriate to recognize PMI in LGD estimates. (p. 44)

In approaching this question four issues must be considered. First, the PMI industry is very concentrated and could lead to correlation of direct loss between lending institutions and an increase in risk of GSE securities, since the GSEs rely upon the PMI companies as a substitute form of capital. Second, while the PMI industry is highly rated by external agencies, the cliff rating criteria set by the GSEs causes those ratings at a minimum to be "sticky." This contention would seem to be supported by the limited range of ratings and differences in scale and capital ratios amongst insurers. Third, the method used to treat the loss mitigant that private mortgage insurance represents in a loan portfolio needs to be roughly equivalent to the benefits the GSEs receive in their capital calculation. It also needs to be roughly consistent with the capital calculations for PMI reinsurers established by many of the large commercial lenders (with appropriate adjustments for the excess of loss layers retained). Fourth, one needs to consider that one is attempting to measure in part "unexpected losses."

Three sources of information on the impact of PMI insurance should be considered authoritative:

- The PMI industry itself has supplied loss statistics to both rating agencies and insurance regulators for decades;
- The GSEs have been required to use PMI insurance and at one time actually ran a private mortgage insurer; and
- Each of the large commercial banks have PMI reinsurers that are subject to banking oversight.

While it is highly likely that on a historical statistical basis less than one-half of one percent of capital is needed for lifetime losses (from Alt A or better obligors) the potential for correlations because of the industry's concentrated nature supports maintaining some floor level of minimum capital.

The Agencies seek views on this issue, including whether the proposed U.S. treatment has significant competitive implications. Feedback also is sought on whether there is an inconsistency in the treatment of general specific provisions (all of which may be used as an offset against the EL portion of the A-IRB capital requirement) in comparison to the treatment of the ALLL (for which only those amounts of general reserves exceeding the 1.25 percent limit may be used to offset the EL capital charge). (p.49)

The Department favors permitting ALLL amounts without limitation to be used against all capital requirements within Tier 2. The oxymoron "general specific" should also be revised and its meaning clarified in future documents. "Specific reserves" as used by U.S. regulatory agencies should be eliminated to follow the general reserves or charge-off approach used in GAAP.

The Agencies seek comment on the proposed methods for calculating dilution risk capital requirements. Does this methodology produce capital charges for dilution risk that seem reasonable in light of available historical evidence? Is the corporate A-IRB capital formula appropriate for computing capital charges for dilution risk? (p. 53)

The materiality of dilution risk needs to be defined, since the proposal would eliminate an additional capital charge when dilution risk is immaterial.

An alternative to the wholesale A-IRB formula is to allow banks to incorporate a factor adjustment for dilution (adjusting EL, in effect), and then to proceed with an internal economic capital calculation, on a reduced EAD. Another alternative is for banks to be allowed to internally model/simulate dilution, as another risk factor, like credit risk, in their internal calculation.

The Agencies seek comments on the methods set forth above for determining EAD, as well as on the proposed backtesting regime and possible alternatives banking organizations might find more consistent with their internal risk management processes for these transactions. The Agencies also request comment on whether banking organizations should be permitted to use the standard supervisory haircuts or own estimates haircuts methodologies that are proposed in the New Accord. (p.57)

The Agencies recognize internally calculated short-term (5-day) PFEs for repo-style transactions with master netting agreements as a measure of EAD. This appears appropriate and consistent with bank practice. However, the requirement to backtest outcomes for 20 counterparties over a one-year horizon for every quarter appears onerous. This frequency should be reduced, and the yellow zone values should be compressed to a single value for simplicity.

Haircuts on standard/liquid collateral should be specified by the Agencies, as those values tend to be commonly known and used across institutions. For non-standard collateral, institutions should be granted flexibility to determine haircuts, subject to supervisory review.

Industry comment is sought on whether a more uniform method of adjusting PD or LGD estimates should be adopted for various types of guarantees to minimize inconsistencies in treatment across institutions and, if so, views on what methods would best reflect industry practices. In this regard, the Agencies would be particularly interested in information on how banking organizations are currently treating various forms of guarantees within their economic capital allocation systems and the methods used to adjust PD, LGD, EAD, and any combination thereof. (p. 58)

It might be helpful for banking supervisors to treat credit derivatives and guarantees as two separate and distinct forms of third-party support. For example, in discussing credit derivatives, the Agencies suggest that the bank need not include restructuring events when it has complete control over the decision of whether or not there will be a restructuring of the underlying obligation. With respect to loan guarantees, if a bank restructures the loan without the consent of the guarantor, the guarantee may in fact be lost. Credit derivatives may use standard documentation from ISDA while there is no similar standard for guarantees.

Under the regulatory capital model, changes to LGD have more impact than changes to PD. It might be more appropriate, depending on industry response, to limit the adjustment to PD only.

There are other forms of third party support that may warrant consideration including completion guarantees, keep well letters and similar arrangements that could be viewed as impacting the grade of a loan. For example, Moody's gives some consideration to such support for captive finance subsidiaries of manufacturing companies.

Comment is sought on this matter, as well as on the possible alternative treatment of recognizing the hedge in these two cases for regulatory capital purposes but requiring that mark-to-market gains on the credit derivative that have been taken into income be deducted from Tier 1 capital. (p. 61)

While the Department appreciates the efforts to deduct one-sided gains from Tier 1, it disagrees with treating credit derivatives differently from other derivative transactions. Under current U.S. GAAP, hedge accounting is by necessity an alternative that banks may choose to use or not. To attempt to fine-tune capital for certain derivatives against this reality is futile. Also, the International Accounting Standards Board's recent proposal to permit macro hedging – which would allow banks active in derivatives tremendous accounting flexibility – represents another example of how different accounting regimes significantly reduce attempts to create a level playing field for regulatory capital.

The Agencies are seeking industry views on the PFE add-ons proposed above and their applicability. Comment is also sought on whether different add-ons should apply for different remaining maturity buckets for credit derivatives and, if so, views on the appropriate percentage amounts for the add-ons in each bucket. (p. 62)

The proposal includes add-on factors for PFEs for the protection seller upon buyer-insolvency while the underlying obligor is still solvent. The factors are the same as for the protection buyer and thus, do not distinguish between buyer and seller. In the event of buyer insolvency, the seller can re-sell/replace the credit derivative in the market place, so seller's loss arises if the NPV of future periodic fees of the new contract is lower than the NPV of remaining periodic fees from the old contract. At worst (when the new credit derivative has zero value – zero default of underlying obligor, or the minimum 3 bp assumed elsewhere in the proposal), this loss is the NPV of remaining fees of the old contract. This figure is generally less than the exposure of the protection buyer which can at worst be notional LGD. Recognition of this difference should be incorporated in the add-on factors. In addition, maturity should be taken into account.

Alternatively, banks should be given the opportunity to use their internal models for calculating PFE for credit derivatives. As noted above, the Department also recommends that banks be allowed to use their internal models to calculate EAD for all OTC derivatives.

Comment is sought on whether the materiality thresholds set forth above are appropriate. (p. 64)

The materiality thresholds appear appropriate, but provisions referring to equity holdings that may be subject to exclusion from capital charges (zero risk weighting) are unclear. It appears that equities of Federal Agencies may be entitled to the exclusion. If this is the case, the guidance does not differentiate between those Agencies that have explicit government guarantees and those that do not. Even if there is an explicit guarantee, is it necessarily true that the guarantee also extends to the equity holder? Bottom line: If a bank is a holder of FNMA or Freddie Mac stock, it is subject to the same risks as come from any other equity security, regardless of the Agencies' AAA credit rating.

In general, the Department would encourage banks to be consistent in using the A-IRB approach across all product lines, but would accept the materiality limits as stated.

Comment is sought on whether other types of equity investments in PSEs should be exempted from the capital charge on equity exposures, and if so, the appropriate criteria for determining which PSEs would be exempted. (p. 65)

The Department recommends that equity investments in Public Service Entities (PSEs) should not be exempted from equity capital charges; if there is equity risk, then there should be a capital charge levied. Any other outcome is based on political policy and not economics.

Comment is specifically sought on whether the measure of an equity exposure under AFS accounting continues to be appropriate or whether a different rule for the inclusion of revaluation gains should be adopted. (p. 68)

The Department would consider changing the capital rules to include net unrealized losses on available-for-sale securities within Tier 1 capital. As accounting standards continue to move toward more of a fair value approach, the rift between accounting and regulatory capital standards grows. If regulatory capital continues to exclude the volatility of investments that will not be held to maturity, it risks ignoring the downside of economic realities. The cushion needed to ensure that prompt corrective action is not triggered when interest rate increases lead to decreases in debt securities' values should be addressed directly rather than by finessing the issue as has been done since the implementation of FASB Statement 115. A similar approach could be taken with net losses from cash flow hedges resulting from FASB Statement 133 in the Accumulated Other Comprehensive Income account.

The grandfathering of equity investments held upon adoption of the final A-IRB capital rule governing equity exposures appears excessive. The Department recommends that grandfathering be reduced to five years.

The Department applauds the Agencies' intention not "to dictate the form or operational details of banking organizations' risk measurement and management practices for their equity exposures," and suggests that this approach be expanded on throughout the guidance where possible.

The Agencies seek comment on the extent to which an appropriate balance has been struck between flexibility and comparability for the A-IRB requirements. If this balance is not appropriate, what are the specific areas of imbalance, and what is the potential impact of the identified imbalance? Are there alternatives that would provide greater flexibility, while meeting the overall objective of producing accurate and consistent ratings? (p. 72)

A major Swiss bank has stated that economic capital between banks is not comparable. The principles-based approach used in the IRB document provides so much flexibility as to make comparability difficult at best. On page 16, banks are given broad flexibility in the ratings philosophy that their credit risk rating system embodies. The flexibility of using point-in-time, though-the-cycle, or hybrid parameters will produce results that are difficult to compare. However, the principles- based approach used by banking supervisors deserves our support.

On page 20 guarantees are discussed. The Department recommends that guarantees should be covered as a separate topic from credit derivatives. Keep well letters and other forms of support should be given consideration as is done by the rating agencies.

Accuracy in rating assignments is defined as the combination of two outcomes: first, the actual long run average default frequency for each rating grade is not significantly greater than the PD assigned to that grade, and, second, the actual stress condition loss rates experienced on defaulted facilities are not significantly greater than the LGD estimates assigned to those facilities. The Department is concerned that accuracy as defined may not be achievable given the current state of the art. For example, Moody's, in "Measuring the Performance of Corporate Bond Ratings (April 2003)," states that the accuracy and stability of its ratings vary over time. Moody's attempts to achieve ordinal rankings and does not try to maintain a constant default rate by rating category. The rating agency looks at cumulative rating profiles and accuracy ratios to evaluate its performance.

Unfortunately, it may be impossible to produce "accurate and consistent" ratings across A-IRB banks. The lack of comparability and difficulty of validation make reliance on disclosure, market discipline, and supervisory review under Pillar 2 essential.

The Agencies seek comment on the proposed operational requirements for securitizations. Are the proposed criteria for risk transference and clean-up calls consistent with existing market practices? (p. 74)

The IRB requirement should mirror the FASB Statement 140 criteria for sales treatment.

Comments are invited on the circumstances under which the retention of the treatment in the general risk-based capital rules for residual interests for banking organizations using the A-IRB approach to securitization would be appropriate. Should the Agencies require originators to hold dollar-for-dollar capital against all retained securitization exposures, even if this treatment would result in an aggregate amount of capital required of the originator that exceeded KIRB plus any applicable deductions? Please provide the underlying rationale. (p. 76)

The Department recommends that the general rule of dollar-for-dollar charge be followed for retention of residual exposures under the following conditions: excessive retention; failure of risk management to adequately demonstrate the validity of prepayment parameters and/or LGD; failure to use an appropriate discount rate; and unclear recourse parameters.

In other cases, capital on retained interests should depend on the credit quality of the tranche held. A loss-modeling approach for each tranche in the portfolio would be a consistent approach to measuring capital. If a bank has the ability to do this loss-modeling across tranches, then it should be allowed to determine the regulatory capital in this manner. This will align regulator standards with existing CDO modeling and risk management practices.

The Department recommends that the KIRB amount (plus applicable deductions) should be used as a maximum capital charge for subordinated risk positions because it presumably is based on the most detailed information. Loss potential need not be the only reason a bank would retain a layer within a securitization.

The Agencies seek comment on the proposed treatment of securitization exposures held by originators. In particular, the Agencies seek comment on whether originating banking organizations should be permitted to calculate A-IRB capital charges for securitizations exposures below the KIRB threshold based on an external or inferred rating, when available. (p. 79)

If credible information respecting the risks of a securitization is available from external sources or methodologies, and these permit a more accurate reflection of loss potential in layers below the internal KIRB calculation, then regulators should permit its use. The purpose of the exercise is to identify the most accurate assessment of risk, not necessarily the highest or lowest. Consistency in treatment between exposures and the statistical credibility of data supporting the external or internal assessments is the key.

In general, originating institutions should be required to request multiple external ratings through all layers of a securitization pool, including non-investment grade rankings that might otherwise be part of a retained position.

The Agencies seek comment on the proposed treatment of securitization exposures under the RBA. For rated securitization exposures, is it appropriate to differentiate risk weights based on tranche thickness and pool granularity? (p. 80)

It is not appropriate because thickness and granularity are already considered in the rating determination.

For non-retail securitizations, will investors generally have sufficient information to calculate the effective number of underlying exposures (N)? (p. 80)

In virtually all instances, the number of underlying exposures is available to investors through standard offering documents, or, if necessary, by contacting the sponsor or servicer.

What are views on the thresholds, based on N and Q, for determining when the different risk weights apply in the RBA? (p. 80)

Neither are appropriate measures because they are already part of the consideration in a rating determination.

Are there concerns regarding the reliability of external ratings and their use in determining regulatory capital? How might the Agencies address any such potential concerns? (p. 80)

Use of multiple ratings by the public markets will identify outlier risk assessments and, when combined with a high level of disclosure, should allay any concerns for ratings obtained from U.S. rating agencies. The Agencies should rely on disclosure, transparency, and market pressure to preserve high quality risk assessments.

Should the A-IRB capital treatment for securitization exposures that do not have a specific A-IRB treatment be the same for investors and originators? If so, which treatment should be applied – that used for investors (the RBA) or originators (the Alternative RBA)? The rationale for the response would be helpful. (p. 87)

Non-rated SS tranches should be distinguished from non-rated equity tranches. The former can be considered to have an AAA rating while the latter would merit dollar-for-dollar deduction.

As an alternative, the use of investor's RBA approach (Tables 1 and Table 2 on page 81), rather than the alternative RBA approach, may be appropriate. Where possible the investor based approach should be applied because it will be most sensitive to changes dictated by economically motivated market participants.

The Agencies seek comment on the proposed treatment of securitization of revolving credit facilities containing early amortization mechanisms. Does the proposal satisfactorily address the potential risks such transactions pose to originators? (p. 90)

The overall structure of the transaction may pose an additional risk to the originator. The initial period may allow for the purchasing of new assets, but the liabilities are paid off at the maturities of these assets. This can lead to a situation where there is too much cash, which does not generate sufficient interest, and this can force an early amortization. The proposal does not take into account the ability of an originator to change the conditions applied to a credit pool. There are market constraints, but if the credit card holders are distressed, their access to other forms of financing is restricted and therefore their ability to switch is inelastic. The Department believes that the application of a 90% CCF for non-retail or committed, is an extreme jump from the highest level for retail (40%). The Department recommends that spreads be applied to this category.

When providing servicer cash advances, are banking organizations obligated to advance funds up to a specified recoverable amount? If so, does the practice differ by asset type? Please provide a rationale for the response given. (p. 91)

Right to full and senior reimbursement is key – so that no cash flows go to investors and other parties unless the servicer gets its money first. The Department agrees with the proposal for zero percent CCF, provided reimbursement is senior to the AAA investors.

Does the broad structure that the Agencies have outlined incorporate all the key elements that should be factored into the operational risk framework for regulatory capital? If not, what other issues should be addressed? Are any elements included not directly relevant for operational risk measurement or management? The Agencies have not included indirect losses (for example, opportunity costs) in the definition of operational risk against which institutions would have to hold capital; because such losses can be substantial, should they be included in the definition of operational risk? (p. 92)

The Department recommends against an overemphasis on risk measurement, whereby the number becomes more important than the process. Indirect losses should not be included in the definition of operational risk, as opportunity costs are difficult to assess. Every decision could be shown to have lost opportunity costs, when evaluated with 20/20 hindsight and perfect information.

The Agencies seek comment on the extent to which an appropriate balance has been struck between flexibility and comparability for the operational risk requirement. If this balance is not appropriate, what are the specific areas of imbalance and what is the potential impact of the identified imbalance? (p. 93)

The Department recommends that the AMA requirements allow for flexibility and comparability of operational risk management. Assessing operational risk management systems is nothing new from a supervisor's viewpoint. Within the examination process, supervisors have always informed management of operational risk deficiencies, and have taken regulatory action if the deficiencies threatened the safety and soundness of an institution. However, the supervisor's focus has been qualitative rather than focused on determining an absolute target number. The supervisor should not lose this perspective.

The Agencies are introducing the concept of an operational risk management function, while emphasizing the importance of the roles played by the board, management, lines of business, and audit. Are the responsibilities delineated for each of these functions sufficiently clear and would they result in a satisfactory process for managing the operational risk framework? (p. 95)

Clearly, corporate governance plays an important role and this should be the primary focus of operational risk management.

The Agencies seek comment on the reasonableness of the criteria for recognition of risk mitigants in reducing an institution's operational risk exposure. In particular, do the criteria allow for recognition of common insurance policies? If not, what criteria are most binding against current insurance products? Other than insurance, are there additional risk mitigation products that should be considered for operational risk? (p. 97)

Risk mitigants should be considered as part of the quantitative approach. Not to do so would seem to be an unfortunate penalty to an institution that includes risk mitigant consideration as part of its overall risk management function.

The Agencies seek comment on the feasibility of such an approach to the disclosure of pertinent information and also whether commenters have any other suggestions regarding how best to present the required disclosures. (p. 102)

The Basel Committee has made a good faith effort to reduce the disclosure requirements – the cost of increased flexibility – for Advanced IRB banks. In response to CP-3, some banks have argued that the disclosure would lead to reverse engineering of a bank's credit portfolio. Other banks have stated that disclosure requirements should only be set by the SEC and FASB.

The absence of such disclosure requirements for the non-bank financial companies with which banks compete is an ongoing issue, and the somewhat disappointing results of the Basel Survey on Public Disclosures by banks suggests that we are at an impasse. It would not be prudent to go forward with Pillar 1 in the absence of a robust Pillar 3. Perhaps the solution would be to split disclosure into two parts: one public, and one to bank supervisors only.

The Department would require institutions to provide all related information in one easily accessible location, with the Agencies determining acceptable locations if not specified in the New Accord. The Department would also require that disclosures be audited by an independent external auditor to enhance accuracy and market reliance.

"Significant events" which trigger prompt disclosures should be defined with the use of illustrative examples. While regulators may require this, the marketplace should provide the discipline by punishing those institutions that avoid prompt disclosures.

Disclosure of operational risk as a number would be difficult: it is a difficult number to arrive at, audit, and attest to. Therefore, a quantification disclosure may not be appropriate. Also, disclosure, with an overemphasis on numbers, could unnecessarily shake public confidence in an institution.

Emphasis should be placed on the operational risk management process that the institution employs. Currently, internal audit should validate management's assertions within the business line as to the operational risk management system and corporate governance. External audit should be able to attest to management's assertion to operational risk management systems and internal control environment, which are already requirements under FDICIA and Sarbanes-Oxley.

Please feel free to contact Katherine Wyatt at (212) 709-1538 or katherine.wyatt@banking.state.ny.us if you would like to discuss our views.

Very truly yours,

Diana L. Taylor
Superintendent of Banks

Appendix A

The Department developed test portfolios of middle market loans to investigate whether risk weights under the A-IRB approach were likely to be lower for middle-market loans to unrated counterparties. The Department chose RiskCalc PDs as published by RMA across industries with particular SIC (Standard Industrial Classification) codes as the measure of probability of default. The Department consulted banks for the allocation of loan portfolios by SIC code, simulated different PD and LGD levels for the loans to a particular industry group (SIC code), and calculated required capital according to the wholesale corporate formula.

RMA publishes three PDs for each SIC code: the PD at the 25% quantile, at the 50% quantile, and at the 75% quantile, when all the PDs have been ranked from lowest PD to highest. These PDs can be considered to cover companies between the 12.5% quantile to the 87.5% quantile since they represent the median PDs of three regions: a "low" region covering companies between the 12.5% and 37.5% quantiles, a "medium" range covering PDs between the 37.5% and 62.5% quantiles, and a "high" region covering the PDs between 62.5% and 87.5% quantiles.

The Department constructed portfolios with loans in, respectively, 125 and 280 SIC categories, and based the portfolio make-up on bank portfolios. These portfolios were relatively unconcentrated, with one portfolio having a maximum share of 10.5% in one SIC code, and the other a maximum share of 6.5%. The average share for SIC code in the two portfolios was 0.4% in one case, and 0.8% in the other. The Department then ran trials of 10,000 simulations, where, initially, low, medium, or high PDs were selected according to a uniform distribution, and then a second draw from a uniform distribution was made from four LGD categories, 25%, 35%, 45%, or 55%. The results of these simulations are reported in Table 3 below. These tests suggest that the appropriate capital charge for middle market loan portfolios could be close to 5.5% instead of the current 8%.

Table 3. Risk Weight Results: 10,000 Trials with Random Draws for PD and LGD Levels

EL + UL risk weight function	Mean	Std.Dev.	Minimum	Maximum
Bank portfolio A (280 SIC codes)	5.7%	0.3%	4.7%	7.0%
Bank portfolio B (125 SIC codes)	5.6%	0.4%	4.4%	7.0%
UL alone risk weight function	Mean	Std.Dev.	Minimum	Maximum
Bank portfolio A (280 SIC codes)	5.2%	0.3%	4.3%	6.2%
Bank portfolio B (125 SIC codes)	5.1%	0.3%	4.1%	6.5%

To explore the effect concentration in one SIC code could have on risk weighting, the Department constructed 280 copies of Portfolio A and 125 copies of Portfolio B, by changing in turn the concentration in one SIC code to 15% and evenly distributing the difference among the remaining SIC codes. A trial of 100 simulations was run for each of these portfolios; the results are reported in Table 4 below. These trials suggest that the impact of concentration could be substantial: the maximum risk weight reported was 8.4%, while the average risk weight reported was 5.6%.

Table 4. Results for "Concentrated" Portfolios: Concentration Varied among SIC Codes

EL + UL risk weight function	Mean	Std.Dev.	Minimum	Maximum
"Concentrated" portfolio A	5.7%	0.5%	4.2%	8.2%
"Concentrated" portfolio B	5.6%	0.6%	3.9%	8.4%