FAC comments on proposed revisions by the federal bank and thrift regulatory agencies to the loan classification framework to increase consistency among the agencies in assessing the credit risk in a bank's commercial loan portfolio.

At the meeting of the Federal Advisory Council on May 6,2005, Gayle M. Earls, President and Chief Executive Officer, TIB – The Independent BankersBank, Dallas, Texas, presented the Council's views on proposed revisions by the federal bank and thrift regulatory agencies to the loan classification framework to increase consistency among the agencies in assessing the credit risk in a bank's commercial loan portfolio.

The Interagency Proposal on the Classification of Commercial Exposures attempts to take a one-dimensional rating system and convert to it a dynamic two-dimensional system. One of the problems with the current system, for example, is two loans both rated substandard; one is fully secured with readily marketable collateral and the other unsecured. Both loans appear identical from an MIS standpoint. The proposed system is two-dimensional because a borrower rating identifies financial statement weakness, while a facility rating quantifies risk of loss.

All respondents except two supported the <u>intent</u> of the proposed two-dimensional rating system. Proponents noted the two-dimensional system better quantified risk in the loan portfolio because of delineation in borrower ratings. Some proponents also noted the two-dimensional system better aligns bank practices with regulatory grading. The opposing view noted the new system would be confusing and burdensome to community banks that are already disproportionately burdened. Opponents also noted the two-dimensional system adds another judgment component to the process, which will be subject to review and criticism by examiners and auditors.

Pros:

- Several respondents representing the larger institutions on the Council noted that a two-dimensional grading system is already in place.
- The proposed borrower ratings of "Marginal,""Weak," and "Default" closely resemble the current definitions of "Special Mention," "Substandard," and "Loss," which should ease transition and training issues.

Cons:

- Several respondents noted the rating called "Default" could be misleading nomenclature. The negative connotation associated with the terminology could taint examiner treatment of such loans and mislead others not familiar with the regulatory definition.
- One respondent noted the new system is not consistent with the requirement of Basel II. Basel II requires the grading of all loans, not just criticized and classified loans. Additionally, a respondent noted the probability of default must be determined for criticized and classified loans. For institutions subject to Basel II, a separate and costly regulatory

grading system will have to be maintained to comply with the interagency statement.

Overall, the Council believes that adopting this proposal, prior to the final agreement on Basel 11, is not advisable. Using Basel II standards in the revision of the loan classification framework, while carefully weighing the smaller bank regulatory costs associated with the change, would promote greater consistency.