To: Basel II NPR Public File

From: Mark Van Der Weide

Date: April 26, 2007

Re: Meeting with Risk Management Association ("RMA")

On April 18, 2007, Federal Reserve staff met with representatives of the RMA to discuss the interagency notice of proposed rulemaking and related supervisory guidance that would implement a new risk-based capital framework based on the Basel II capital accord. Representatives from the OCC, OTS, and FDIC were also present. Before the meeting, the RMA submitted the attached detailed list of questions on the proposal. The meeting followed the outline of the questions presented. A list of attendees is also attached.

Attachments

Date: April 13, 2007 FINAL

To: Banking Agency Basel II Staff

From: RMA Capital Working Group

Re: Questions of Clarification on Supervisory Guidance Package

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This outline suggests major topics of conversation for our scheduled April 18, 2007 meeting in Washington, D.C. Our questions are grouped into major categories and each question relates to a supervisory standard or page number in the February 15, 2007 version of the Guidance release (not the Federal Register version). Capital Working Group ("CWG") members may have additional questions of clarification at the April 18 meeting that, because of the compressed work schedule, were not included in this outline.

RMA requested this meeting with the agencies for clarification purposes. We are not attempting to advocate any particular approach over another, but simply hope to discuss the range of industry practice.

Please note that some of our questions are in the direction of asking for more specifics. We do not intend that such questions be treated as a request for the supervisors to be more prescriptive. Rather, examples of treatment that would pass muster are quite useful, since they do not preclude alternative cost-effective procedures that achieve the same result. However, we are concerned over the Guidance's statement (Chapter 4, paragraph 7) that examples of procedures that are deemed, in this Guidance, to pass muster should not be viewed as "safe-harbors" without fully considering all of the requirements of the Guidance. First, we recognize that no one example can fully incorporate all of the issues facing all banks. Second, we fully appreciate that the Basel II implementation and maintenance process is an "evergreen" one. However, cost-effectiveness requires that the agencies provide a sense of the range of acceptable practice at an early date (preferably by the completion of the final Rule and Guidance). We are fully aware, that, as the range of acceptable practice shifts over time, in response to evolution in best-practices, some institutions may need to update the specifics of their internal procedures.

We group our questions and comments below into certain high-level issues, then proceed to more specific issues of risk parameter estimation. Attachment 2 covers questions regarding operational risk, and Attachment 3 relates to Pillar 2. We have not treated in this memorandum issues pertaining to counter-party credit risk and, as noted above, this outline represents an incomplete listing of our members' concerns.

Finally, note that none of the statements or examples provided by us should be viewed as positions that are endorsed by RMA or necessarily any individual member. Rather, we are trying to provide as much clarity as possible with respect to our questions.

A. <u>High-Level Issues</u>:

1. Board approval requirements associated with Board of Directors' participation (p. 23; S1-3).

The bank's Board is required to annually evaluate the "effectiveness" of the bank's advanced systems. Additionally, there are many other processes associated with Basel II implementation – including the Pillar 2 process – that require Board approval. See Attachment 1, which summarizes these various requirements. While we can understand these approval requirements for the senior management of the bank, do regulators expect Board committees to directly conduct all these evaluations and approvals or is the Guidance referring to the process of Board members asking questions of the management for clarification purposes or indicating that depth of presentation to the Board in some areas needs to be improved?

2. NPR qualification requirements/agency approval requirements, and steps for approval during the parallel reporting and transition periods (pp. 182 and 23)**.**

The only substantive discussion of the agency approval process appears at the end of the operational risk document (Appendix C, which repeats Section 21 (b)(8) of the NPR) and which presumably applies to both AIRB and AMA. Please walk us through these steps. For example, the mandatory or opt-in institution should notify the appropriate agencies that it intends to start the parallel-reporting period on a certain date. The bank must receive agency approval to move to the first of the transition periods. There is no discussion of how this approval process works. Is there substantial agreement across the agencies on the timing and implementation of the approval process?

3. Previous model validation guidance and documentation standards (Chapter 1, S1-6)**.**

    a. Do the standards inherent in previous agency guidance – such as OCC 2000-16 with regard to model validation and documentation or SR 99-18 with regard to internal capital adequacy determination – apply to the Basel II process? If so, does the definition of "model" inherent in OCC 2000-16 differ from use of the term in Basel II?

    b. The current Guidance appears to place significantly more emphasis on documentation than previously. What will be the process by which Basel II banks will receive more detailed guidance on documentation standards? Greater reliance on existing agency guidance would be less burdensome for the industry and perhaps also benefit inter-agency coordination of implementation efforts since examiners are already using existing guidance(s).

4. Annual review of risk parameter estimation. (Chapter 4, S4-6, paragraph 29).

We appreciate the more general language that risk parameter estimation should be reviewed annually rather than updated annually. We seek clarification that review need not include a full re-estimation and documentation process when the risk parameters need not be updated. For example, where the addition of another year's worth of data does not result in a significant change in mean default rate for a segment, is such evidence sufficient to show that re-estimation of regressions at the loan level, if that is the approach used by the bank, is not required?

B. <u>Broad credit risk metric issues encompassing both Wholesale and Retail</u>.

1. <u>LGDs and ELGDs</u>.

   a. The Guidance indicates that LGDs are "affected by collateral values" not just the existence of collateral, and that banks with a high concentration within an ELGD or LGD rating grade should perform a statistical analysis supporting this concentration. (pp 33-34; paragraphs 37, 40) We seek clarification that this language does not preclude the use of a single product-level ELGD, or the use of a collateral vs. no-collateral ELGD distinction. In particular, less-disaggregated ELGDs may be appropriate in cases where low default rates lead to inadequate data for estimating more-disaggregated ELGD measures.

   b. The Guidance generally indicates that, when using the Supervisory Mapping Function (SMF), ELGD needs to be an empirically based estimate of economic loss-given-default over a mix of economic conditions, including economic downturn conditions. However, a major reason for using the SMF is that the bank may not possess *internal* economic LGD data for a product or category of AIRB retail loans during a downturn (for that category). Moreover, external industry data on historical economic LGDs for retail products may not be readily available or available at all. We seek clarification that, so long as the bank has, at the internal level, economic LGD data for the sufficient minimum number of years, it may use the SMF to impute the downturn LGD.

   c. Could we receive clarification of the "economic downturn conditions" during which LGD is to be measured? Chapter 8 makes reference to using "recession scenarios." Please comment.

   d. We seek clarification that in the presence of statistical work or other analysis that shows little or no correlation between default rates and LGDs, the SMF would not be applied. For example, credit card LGDs generally are high (90% or more for many segments) and exhibit little variation over time. This could be the case for other qualifying revolving exposures as well. For this retail product category, are the LGDs measured during the number of years for which internal LGD data are available sufficient to estimate LGD (so long as the minimum number of years of data are available)?

e. "Judgmental adjustments are not to be biased toward lower risk parameters." (S4-11).

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

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

   Does this "pooled basis" requirement preclude the use of individual defaulted asset cost and recovery data in estimating LGDs (e.g., through regression analysis)?

2. Definition of default.

   a. Chapter 3, paragraph 14 indicates that, for wholesale, all obligations of an obligor are in default if any one defaults. Have the agencies given consideration to the treatment of certain types of wholesale credits, such as multi-family loans, in which the behavior of revenues associated with the collateral is what determines default and, given that there are explicitly no cross-default provisions in any of the facilities, borrowers typically only default on a single facility (due to local conditions with regard to the one piece of collateral)? The default probabilities for each of the facilities for such obligors have been shown to be not equal. Therefore, have the agencies considered applying an “all or none” rule for defaults, say, for all non-revenue-generating collateralized or non-collateralized facilities for a single wholesale obligor?

b. If market data indicate that an obligor is in default on exposures not held by us (e.g., has filed for bankruptcy), and we have an exposure to the obligor that is current and/or is fully secured, do we consider this obligor in default and use this observation of default within our reference default database? (One of our members notes that when there is adequate protection in such a circumstance, and the borrower would continue to pay interest, internally the loan is kept on accrual status. Also internally, the loan is treated as a default, resulting in a higher PD, but lower LGD to reflect the continued payment on the obligation.)

3. <u>EAD estimation</u>.

a. We seek confirmation that, in products where pay-downs of principle outstanding prior to default are common (such as in the case of asset-based lending), while EAD cannot be set below current balance, ELGD and/or LGD may be measured relative to EAD rather than relative to the actual amount owed at default. While this procedure is unwieldy, it would provide a method for recognizing negative LEQs for certain categories of unused lines.

b. We seek confirmation that for term loans, with or without scheduled amortization, and with no “line of credit” feature, a “safe harbor” is EAD = 100% of current balance.

c. Some of our members have developed their EAD-LGD approach using the Framework’s option of reflecting further drawings in LGD (for example, by including additional unpaid interest and fees in a manner that increases LGD). May we assume that the spirit of the NPR is met with such treatment?

d. Eligibility for EAD adjustment (with respect to counterparty credit risk). As per the last sentence in Chapter 9 - V. "Determination of Eligibility for EAD Adjustment" (S 9-2. paragraph 14), "banks should consider whether transactions otherwise eligible for the EAD adjustment approach are subject to the automatic stay under the U.S. Bankruptcy Code or similar provisions under other applicable bankruptcy law." We seek further clarification on the intent of this statement.

e. With respect to the fixed-horizon method for estimating EAD (Chapter 4, paragraph 139), isn't the fixed-horizon one year?

f. Paragraph 141, Chapter 4 states that "To derive EAD estimates for lines of credit and loan commitments, characteristics of the reference data are related to additional drawings on an exposure up to and after the time a default event is triggered. Estimates of any additional extensions of credit expected by a bank subsequent to realization of a default event should be factored into the quantification of EAD. The estimation process should be capable of producing a plausible average estimate of draws on unused available credit (e.g., LEQ) to support the EAD calculation for each exposure or retail segment.

Typically, the accounting and economics of post-default extensions to the obligor argue for treatment of such extensions to increase LGD, not EAD. Such extensions would generally take place within the context of a wholesale exposure.

1) The accounting of extensions after non-accrual typically is as an expense (increasing costs of recovery).

2) From an economic perspective, the bank will make such an extension only if it would help to improve recoveries net of costs. An example would be to help a builder complete construction in order to enhance sale value of the collateral.

Because of this, bank risk measurement systems may be set up to treat such post-default expenses within the LGD estimate. Because both EAD and LGD enter the AIRB credit risk equations in linear fashion, the regulator should have no objections to using the post-default expense treatment described above. Indeed, if the bank is using the SMF, then ELGD treatment of post-default extensions would a) result in higher capital calculations and b) be less expensive from a compliance standpoint. Could we receive comment on this issue?

4. Treatment of guarantees.

a. We seek clarification on the need for calculating the PD of the obligor first, then again in the presence of the guarantee (S4-3). There are a number of circumstances where it is unnecessary or impractical to calculate the PD of the obligor – for example, where there is on guarantor for multiple obligors. In these cases, the bank evaluates the guarantor, not the individual obligors, and documents such exposures accordingly.

In the case where, for the product in question, the guarantor typically makes good on scheduled principal and interest payments to effectively head off default, there is no economic need to estimate a PD for the obligor. An example is a loan to a business in which a guarantee is provided by the lead partner in the business. We typically would not seek and receive such a guarantee unless the guarantor's PD is likely better (lower) than that of the business – if, by some chance, the opposite were true, then the calculated capital requirement would indeed turn out to be conservative. Cost effectiveness calls for not requiring the bank to calculate the business' PD when such a risk parameter has no use in risk measurement or management.

We understand that, not only does S4-3 require that the bank quantify both "before-guarantee" PDs and "after-guarantee" PDs, but also the proposed reporting schedules require that both of these quantities be reported. However, we believe that there is no appropriate use of these data, by the bank management, the regulators, or the shareholders. The before-after data can be confusing at best and misleading at worst. For example, if there is a wide (narrow) gap between the guaranteed-PD and the un-guaranteed PD, is that indicative of a) shortcomings (strengths) in the bank's PD measurement system; b) success (failure) in the bank's risk management policies via the significant reduction of default risk; c) artifacts in the particular type of lending business in which the bank engages; or d) not necessarily any of the above?

b. Implied support (S 2-11). The conditions for using implied support in the estimation of PD seem too prescriptive and, as such, may be inapplicable in the practical sense**.**

1) Are the 10 bullet points under paragraph 35 (after S 2-11) *all* to be met in order for implied support to be recognized?

2) Are the agencies open to alternative suggestions to determine whether "broad market recognition" for implied support exists? In the examples given in the text – using external ratings of the parent versus a subsidiary, or using traded credit spreads of the two – the examples seem to apply to individual liabilities of individual related obligors. It is not obvious to us how such data would support "broad market recognition."

3) May banks use supervisor-approved internal ratings to meet the "investment grade" rating requirement in the case when the implied support is from a guarantor that does not have a public rating (i.e., a low-risk private firm)?

4) The condition that the bank has established a stand-alone rating for the obligor (subsidiary), and *continues to monitor this rating throughout the term of the exposure* is not common industry practice. In addition, as discussed above, both the before- and after-guarantee PD calculations are required. Please indicate how such information would be used by the bank or its supervisor.

5) Please clarify how the implied support to a subsidiary is to be incorporated into the obligor-rating of the parent. Does this mean that, in any case in which a bank recognizes implied support in the rating of a facility to a subsidiary, the rating of the parent (if we have an exposure to the parent) must treat the subsidiary liability as a liability of the parent?

c. Chapter 4, paragraph 18 provides that private mortgage insurance would be considered a guarantee. By extension, would not private student loan guarantees/insurance also be considered guarantees? Similarly, would the guidance regarding credit quality deterioration of a private mortgage insurer (Chapter 4, paragraph 21) also apply to other guarantors?

5. Other credit risk issues:

a. Does the bank need to include, within its actual wholesale grading system, a separate grade for defaulted assets? Or is it simply the case that defaulted asset balances and other data must be maintained for regulatory capital risk parameter estimation purposes?

b. With respect to the periodic (at least annually) re-grading of exposures, may exposures in *de minimus* buckets (subject to 100% risk weights) be exempted from such periodic re-grading?

c. Chapter 4, paragraph 78: "*Key drivers of default should be factored directly into the obligor rating or segmentation process. But in some circumstances, certain effects related to industry,* *geography, or other factors are not reflected in wholesale obligor risk rating assignments, retail segmentation, or default estimation models. In such cases, it may be appropriate for banks to capture the impact of the omissions by using different mappings for different business lines or types of exposures. Supervisors expect this practice to be transitional, and that banks eventually will incorporate the omitted effects into the wholesale obligor risk rating, the retail segmentation system or the PD estimation process as they are uncovered and documented, rather than adjusting the mapping."*

What would compliance with this requirement look like?

d. Judgmental overrides (Chapter 7, 7-11; paragraph 38).

In considering process verification, the guidance states that " 'Judgmental overrides' occur when judgments are made to reject the decision of an objective process, such as a model or scorecard, which rates a wholesale obligor, assigns an exposure to loss-severity rating grade, or assigns an exposure to a retail segment; judgmental overrides are an explicit component of such a rating system's design." We seek clarification. Do "judgmental overrides" occur in those systems where the application of judgment is the essential normal component used in arriving at a rating?

C. Detailed risk parameter issues pertaining to Retail.

1. Seasoning (S 4-18).

a. The language on seasoning appears to be substantially changed from the prior retail guidance of October 27, 2004. In particular:

- This Guidance indicates that the bank may use the one-year PD even when age is statistically important, so long as the bank can show that the portfolio's age distribution is stable over time (and will likely be stable in the future?) and the portfolio is not concentrated in low age loans.
- Also, loans subject to seasoning effects, but originated for sale within a 90-day time frame, would not require the use of the annualized cumulative PD.

b. Is our understanding of these changes accurate?

c. Will there be specific agency tests for "stability" in age distribution?

d. Are there other issues pertaining to seasoning that are not fully or finally addressed in the guidance?

e. We seek clarification that there is no requirement for the bank to calculate capital “both ways” – using ACPDs vs. using one-year PDs – so long as either of the two conditions above are met or, alternatively, internal statistical analysis indicates that there is no age-related effect on PD (for example, when all other appropriate risk explanatory variables are considered). More specifically, we seek confirmation that there must be a statistical significance to the impact of seasoning to require use of the ACPD – not just some minor absolute effect obtained through the use of simple averages employing only a single explanatory variable (age).

f. Example 4 appears to say that the time formula should not be used, but rather banks should use a simple division to arrive at the “ACDR”. Note also that the Guidance uses the term “average cumulative default rate” (a realized rate) rather than average cumulative probability of default (an estimated number), presumably because the authors are not referring to the case in which a loan-level PD estimating process is used. In the case of such loan-level PD estimation, the estimated cumulative default probability for a single loan is not the simple average of default rates within the segment over the estimated remaining life of the loan type. Nor would the balance-weighted aggregation of loans’ ACPDs for a segment necessarily be identically equal to the ACDR for the segment over the time horizon estimated for the type of loan.

   Going beyond the use of the time formula, do the supervisors have suggestions about how estimated remaining life should be measured? Estimated cumulative default rate?

   For assets with greater than 5 year expected remaining lives, we need more than the minimum 5 years of data, correct?

g. Other examples in the text, such as Example 2 (Chapter 4, Paragraph 98) suggest that prepayments are a “deferral” of losses. Please clarify.

2. <u>Portfolio segmentation</u>.

Some statements in the Guidance regarding segmentation requirements appear to be at odds with other statements regarding acceptable segmentation and/or risk parameter estimation procedures or with respect to standard industry practice:

   a. Accounts in a retail product segments must have homogeneous risk characteristics (Chapter 3 NPR Section 22(b)(3) and S3-2), for example that the accounts with similar ranges of FICO, LTV, etc. have similar performance. This is not the same as the practice of grading wholesale obligors whereby a single PD is applied to obligors in that grade. In the wholesale case, two obligors can have the same PD grade but widely varying risk characteristics (one obligor is highly leveraged but has a high debt service coverage ratio; another obligor has low leverage but also a lower debt service coverage ratio).

The retail homogeneity requirement could be interpreted as precluding the use of PD-LGD defined segments, which some Basel II banks may desire to use. That is, two accounts in the same PD bucket can have widely varying risk characteristics (one has high FICO and high LTV, the other has low FICO but low LTV). We seek clarification that retail segments may indeed be defined by PD-LGD ranges, which would specifically mean that a single PD-LGD bucket may have accounts with widely varying risk characteristics, but exhibit a single PD and a single LGD for the bucket. In this regard, we note that the proposed Call Report provisions call for reporting exposures within PD-LGD ranges for retail products. A technique used by some banks has been to calculate PDs and LGDs at the loan level, then assign individual accounts to PD-LGD buckets/segments (such as those required in the new Call Reports), then calculate each such bucket's PD and LGD. (See d. below)

b. For residential mortgages, the Guidance requires that a bank "should not artificially group exposures into segments specifically to avoid the 10 percent LGD floor for mortgage products." (Chapter 3, paragraph 13). We seek clarification of acceptable methods to address this without producing a bias in the opposite direction, i.e. artificially raising capital requirements through application of the 10% LGD floor. .

   For example, segmenting below the national level (at the level of the state or MSA) may uncover geographic regions where house price declines lead to high LGDs, while in other areas, house price stability or appreciation may mean low LGDs. If the 10% LGD minimum is applied at less than the national level (or at finer delineations of LTV) this discourages such detailed examination. We seek guidance on how to satisfy appropriate economic segmentation, which may produce LGDs below10% in some segments), without invoking the unintended effects of the 10% minimum LGD rule.

   We note that while ELGDs below 2% are bound by the 10% LGD limit, low ELGDs over 2% require incrementally more capital beyond the 10% floor due to the application of the SMF.

c. Use of account level risk parameter estimation. The guidance (chapter 4, paragraph 55) states "… a bank should have a clear and well-supported policy regarding how aggregation should be accomplished. Banks are required to have a quantification system in which the rating grades or segments are homogeneous with regard to risk; in this case, each obligor or exposure within homogeneous grades or segments would receive equal emphasis in quantification." We seek clarification whether this requires for retail segments that loan-level PDs be aggregated up to the segment by using a simple account-level average or a balance-weighted PD average.

d. With regard to the requirement that national jurisdiction of assets result in separate segmentation (Chapter 4, paragraphs 121-122) – we seek confirmation that such segmentation does not require that modeling of risk parameters be conducted separately for separate national databases. In particular, some banks utilize regression or other models employing world-wide data, in which dummy variables (and/or interaction terms) are used to designate national jurisdictions. The requirement for national jurisdiction segmentation, therefore, is not the same thing as requiring national jurisdiction database segmentation for purposes of model-building – correct?

e. (Chapter 4, S4-17 and paragraph 62) The PD must represent the "long run average of segment default rates." We seek clarification that this characterization does not preclude the use of loan-level PD estimation equations with time series data to estimate a current PD for each loan, and then aggregating to the segment level.

f. Chapter 4 Paragraph 5 indicates that the bank should apply "statistical techniques to the reference data to determine the relationship between risk characteristics and the estimated risk parameter." However in Chapter 3, paragraph 7, the guidance indicates that "expert judgment" may be used to determine the most relevant risk drivers for retail segmentation. Please clarify.

g. Chapter 4, paragraph 60 states that a "bank should assess the characteristics of its existing portfolio relative to the characteristics of exposures in the reference data." It is not clear whether this is strictly an issue of proper "mapping." If so, please refer to our further questions on mapping below.

h. The Guidance also appears to remove the requirement in the 2005 draft that segment definitions be reviewed annually. We appreciate this effort to make the Basel II implementation more cost-effective and seek clarification of the requirement that banks still need to periodically review the appropriateness of the segmentation definitions.

3. <u>Mapping for retail exposures</u>.

   a. There is an explicit requirement to map variables between the reference database (RDB) and the current portfolio – but more examples could help clarify what measures would satisfy the mapping requirement. For example, if the current portfolio has a different composition from the RDB (relatively more accounts in one segment and fewer in another), yet there are still large numbers of accounts in each of the segments of the current portfolio, what would "mapping" mean? In particular, what would "mapping" mean, if there is no evidence to suggest that the underlying drivers of risk are different that in earlier years, or have different weights (in terms of their influence on default frequencies) than in earlier years?

b. Chapter 4, paragraph 51, indicates that the bank "should verify that the risk factors behind the segmentation capture the same types of borrowers in today's portfolio as they did in the reference data." We seek clarification on this sentence.

4. Tranched guarantees for retail pools. (Chapter 4, Appendix B, Example 5)

The Guidance indicates that such guarantees might be handled via securitization treatment.

a. We wish to clarify that a bank has the option to compute capital without the guarantee rather than using securitization treatment.

b. We seek guidance whether a bank can also treat the guarantee within its estimate of ELGD or LGD for the assets in the pool. One example of such a "tranched guarantee" would be a retail asset pool purchase (by the bank) in which there is a hold-back of the purchase price based on realized pool losses exceeding some level. In effect, the hold back is a second-dollar loss position held by the seller. From the purchasing bank's vantage point, the hold-back protects the bank from losses above the loss reserve set at the time of purchase. Can the hold-back be captured within a lower-than-otherwise LGD estimate for the assets in the pool?

D. Treatment of equity positions. (Chapter 10)

1. The Guidance does not mention the possible grandfathering of equity investments, as we discussed in our response to the NPR. What is the status of this issue? In particular, there is a provision in the Accord that Basel countries may grandfather certain exposures for up to 10 years. Have the agencies considered a simple rule that currently grandfathered equity exposures would continue to receive 100% risk weight treatment until the exposures leave the balance sheet? We seek any clarification you can give us on this issue.

2. Validation of internal models for equity exposures (Chapter 10 section V, S10-3 and paragraph 22). The Guidance requires comparison of the internal model to the output of a VaR model (based on historical price results over a time horizon of

one quarter for a benchmark portfolio). We seek guidance on how this might be done in the case of a portfolio of private equities.

3. The NPR rule defines an investment fund exposure that will not be treated under securitization treatment as one in which the investment company has no material liabilities. We seek guidance on the definition of "liability" in this context. Does it include all liabilities including working capital? Similarly, we seek guidance on the definition of "material" in this context.

E. Other Issues.

1. "Use Tests." (Chapter 7, Section III; S7-5)

The use test language seems to be more practical than in the earlier guidance packages (in 2003 and 2005). In this Guidance, the key appears to be that the internal AIRB approach must be "consistent" with internal risk management procedures – as distinct from a requirement that the bank must actually use, for example, the AIRB segments themselves and/or the AIRB risk parameter calculations themselves, within the process of internal risk measurement and management. We seek confirmation that this interpretation of the Guidance language is correct, and if so, we congratulate the agencies on their efforts to make the Basel II implementation process as practical as possible (and as cost-effective as possible), without compromising the ability of the new regulatory capital procedures to set minimum capital requirements.

2. Asymmetrical treatment of risk management changes (Paragraph 30, chapter 4).

This section states that "The risk parameter estimates may be particularly sensitive to changes in the way banks manage exposures. When such changes take place, the bank should consider them in all steps of the quantification process. Changes likely to significantly increase a risk parameter value should prompt increases in the risk parameter estimates. When changes seem likely to reduce the risk parameter value, estimates should be reduced only after the bank accumulates a significant amount of actual experience under the new policy to support the reductions." Would you comment on the purpose of this asymmetrical treatment?

Attachment 1

Board of Directors – Summary of Basel II Responsibilities

	Requirement	Timing	Source(s)
1.	Board (or a designated committee of the board) must evaluate the effectiveness of and approve the bank's advanced systems.	At least annually	[SG] CR-S 1-3 [NPR] Section 22(j)(2)
2.	Internal audit must assess the effectiveness of the controls supporting the IRB system and report its findings to the Board (or a committee thereof).	At least annually	[SG] CR-S 7-6
3.	The Board must approve the bank's written implementation plan to comply with qualification requirements	One off	[SG] Appendix C, B8 [NPR] Section 21.b.8
4.	The Board must evaluate the effectiveness of, and approve, the bank's AMA System, including the strength of the bank's control infrastructure.	At least annually	[SG] OR- S 4
5.	Banks may use independent and qualified internal (e.g., internal audit) or external parties to perform verification and validation. These functions should assess and report to the Board on the adequacy of the overall AMA System. Appropriate reports summarizing the results of independent verification and validation of the bank's AMA System, including associated models, should be provided to the Board and appropriate management. The board should ensure that senior management initiates timely corrective action where necessary.	Annual	[SG] OR- S 32
6.	The Board and management should ensure that the bank's operational risk management, data and assessment, and quantification processes are appropriately integrated into the bank's existing risk management and decision-making process and that there are adequate resources to support these processes throughout the bank.	On-going	[SG] OR-S 5
7.	The Board and senior management must receive reports on operational risk exposure, operational risk loss events, and other	Quarterly	[SG] OR-S 10

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

Key:
SG = Supervisory Guidance
MR = Market Risk NPR (9/5/06)
NPR = Credit and Operational Risk NPR (9/5/06)

Attachment 2

AMA Group Questions:
Proposed Supervisory Guidance

Following are questions about the Supervisory Guidance on AMA for Operational Risk from the AMA Group[1]. They are being submitted for review and discussion with Agency representatives on April 18, 2007.

Revisions to the ANPR Supervisory Guidance

During the course of the AMAG's side-by-side comparison of the new NPR Guidance to its predecessor ANPR Guidance, which was issued in 2003, the Group has identified numerous small changes that have been made throughout the original document. The AMAG's discussions with regulatory Agency representatives prior to release of the NPR Guidance had left us with the impression that we should not expect major changes.

Although a number of the changes identified might fall into the category of clarifications, many others are characteristic of the expansion of rules and lengthening of requirement lists, and in a few cases imperative language references (i.e., "must" and "should") were changed. Individually most of the changes appear minor, but collectively they appear to have the effect of far more prescriptive Supervisory Guidance overall.

<u>Question 1</u>: Please describe the general intent of these numerous changes. Why were so many changes deemed by the Agencies to be necessary? It is correct to assume that most of these changes were not intended to be major? Inasmuch as the AMAG has been working intently toward implementation, it requests that the Agencies identify which of these changes are intended to be most significant.

Notification Requirements, Supervisory Standards

This section of the Guidance includes the statement: *"This guidance should not be interpreted as weakening or superseding the safety and soundness principles articulated in existing … regulations or guidance issued by the Agencies."* (SG p. 200)

[1] The Advanced Measurement Approaches Group (AMAG) was formed in mid-2005 at the suggestion of the U.S. Inter-Agency Working Group on Operational Risk. The AMAG is open to any banking and/or financial institution regulated in the United States that is either mandated, opting in, or considering opting in to Basel II. A senior officer responsible for operational risk management represents each member institution on the AMAG. Of the twenty-two or so US banking institutions that are currently viewed as mandatory or opt-in Basel II institutions by the U.S. regulatory Agencies, fifteen are currently members of the AMAG. The Risk Management Association (RMA) provides the secretariat for the AMAG.

Question 2: The AMAG requests clarification of the implication of this statement. In the course of reviewing the NPR and Guidance documents, the Group identified several instances of potentially contradictory language between them. Is it possible that in its elaboration on the NPR text, the Guidance includes instances that actually do supersede the prior document? The AMAG has attached an excerpt of its response to the NPR on Unit of Measure, which provides an example.

Supervisory Objectives and Approach

The Guidance states that *"In performing their evaluation, the Agencies will exercise supervisory judgment in evaluating both the individual components and the overall AMA System. The NPR provides that the primary Federal supervisor may require a bank to assign a different risk-weighted asset amount for operational risk, to change aspects of its operational risk analytical framework (for example, distributional or dependence assumption), or to make other changes to the bank's operational risk management processes, data and assessment systems, or quantification systems if the supervisor determines that the risk-weighted asset amount for operational risk produced by the bank is not commensurate with the bank's operational risk profile…." (SG p. 201)*

Question 3: Please provide a representative scenario, along with a discussion of timeframe, under which required changes might be imposed. That is, (a) presuming that the primary supervisor would have reviewed and approved the AMA System of the bank in question during the course of its Qualification phase and Parallel run period, what would be the nature of changes that would be required later? (b) In view of the fact that such changes would likely be disruptive to the AMA System and the bank in question, using the same example please provide some indication of the lead time that might be expected and / or allowed from the time that the supervisor might make such determination to such time as the changes are to be implemented.

Scope of Examination Implied by the Guidance

As noted, the NPR Supervisory Guidance has become considerably more prescriptive and far-reaching in scope from its ANPR predecessor, and in the detail of specific Standards. Example: The detail included with S. 4 and S. 5 describes management responsibilities for ensuring that, among other things, that "Compensation policies are sufficiently flexible to attract and retain qualified and competent operational risk expertise." (SG pp. 206-207)

Question 4: How will a regulatory examination be implemented on points such as this where the scope of the issue extends outside the control and authority of the senior manager responsible for operational risk? That is, in this specific instance, will the examination expand well beyond the scope of the operational risk management, audit and business line functions to Human Resource and other functions, as well?

Analytical Framework

Standard 25 states that “The bank must review and update its operational risk quantification system whenever it becomes aware of information that may have a material effect on the bank’s estimate of operational risk exposure or risk-based capital requirement for operational risk …” The explanatory detail goes on to say that “Senior management should determine and document which components of the quantification system will need to be revised prior to recalculating the bank’s operational risk exposure and operational risk capital requirement due to any identified material change in inputs or assumptions….” (NPR SG. Pp. 217-218)

<u>Question 5</u>: The AMAG requests clarification of this requirement. For instance, please provide clarification of the threshold of materiality of changes in inputs. We interpret the phase “which components of the quantification system will need to be revised” as referring to structural changes in the quantification system only, which would occur rarely. Is this a correct interpretation? Also, who would constitute ‘senior management’ in the context of this Standard?

Attachment 2-A
Example of Inconsistency between the NPR and Supervisory Guidance

(Excerpt from AMA Group response to the NPR)

Unit of Measure

a. NPR and Supervisory Guidance References

The NPR explicitly introduces and defines the concept of "unit of measure." The proposed rule defines a unit of measure as *"the level (for example, organizational unit or operational loss event type) at which the bank's operational risk quantification system generates a separate distribution of potential operational losses."* (Federal Register Vol. 71, No. 185, p. 55852; Supervisory Guidance p. 203)

The NPR goes further to say that, for a data grouping to be acceptable as a unit of measure for a specific loss distribution, a *"… bank must [also] demonstrate that it has not combined business activities or operational loss events with different risk profiles within the same loss distribution."* (Federal Register Vol. 71, No. 185, p. 55852)

The Supervisory Guidance includes Standard No. 27. This states: *"The bank must employ a unit of measure that is appropriate for the bank's range of business activities and the variety of operational loss events to which it is exposed, and that does not combine business activities or operational loss events with different risk profiles within the same loss distribution." (Supervisory Guidance p. 219)*

In the explanation that follows, the Supervisory Guidance goes on to say: *"Banks should weigh the advantages and disadvantages of estimating a single loss distribution or very few loss distributions (top-down approach), versus a larger number of loss distributions for specific event types and/or business lines (bottom-up approach). One advantage of the top-down approach is that data sufficiency is less likely to be a limiting factor, whereas with the bottom-up approach there may be pockets of missing or limited data. However, a loss severity distribution may be more difficult to specify with the top-down approach, as it is a statistical mixture of (potentially) heterogeneous business line and event type distributions." (Supervisory Guidance p. 219)*

"Supervisors will consider the conditions necessary for the validity of top-down approaches and evaluate whether these conditions are met in their particular individual circumstances." (Supervisory Guidance p. 219)

b. Discussion

… this NPR language and the language of Standard No. 27 itself are not consistent with the explanation that follows the Standard. The S.27 and NPR language preclude the use of top-down approaches because a loss distribution estimated on a firm-wide basis will certainly combine *" … business activities or operational loss events with different risk profiles within the same loss distribution."*

The language following S.27, however, explicitly allows for top-down capital estimation approaches. It also goes from a single criterion – homogeneous risk profiles – to two criteria – homogeneity of risk profiles and data sufficiency….

ATTACHMENT 3

Internal Capital Adequacy Assessment Process (ICAAP) – Pillar 2

The discussion of ICAAP is included under a section entitled Proposed Supervisory Guidance on the Supervisory Review Process (Pillar 2). Although many risk professionals would agree in principle with its content, the section is written in an informational style that does not provide specific rules or requirements, per se. Instead, to a large degree it appears to provide risk management practice options to institutions for their internal processes. As such, it also might imply extensive latitude for Pillar 2 enforcement.

Could the agencies provide a more complete understanding of the application and enforcement of this section? Presumably the section's discussion of risk management, which exceeds the current regulatory requirements, is not simply being provided for information purposes. As written the section could provide extensive scope for field examiners to find fault with virtually any bank's risk management program, if desired. (SG pp.247-254).

Internal Capital Adequacy Assessments are expected to improve as they evolve over time (paragraph 36). Do the agencies have any more specific guidance on the supervisory expectations for ICAAP at the start of the parallel reporting period, the transition periods, and over time? Also, what is the timing with regard to completing documentation of ICAAP (paragraphs 34ff)? Since Pillar 2 is equally as important as Pillar 1, when can we expect more detailed guidance on this subject?

RMA/Interagency/System Meeting
Basel II Guidance
April 18, 2007 (10:30-3:30)
List of Attendees

RMA
Pamela Martin
Ed DeMarco

Bank of America
John Walter

Capital One
Bill Nayda
Lin Li

Citibank
Fenton Alymer

HSBC
Andrew Marrus
John Roesgen
Mary Ann Hagerman

JPMorgan Chase
Michelle Rosenthal-Hubertus
Gregory DeVany
Jim Colton
Joe Lyons

Op Risk Advisors
Doug Hoffman

Promontory
John Mingo
James Kamihachi

RBC
Ron Baird

State Street
Kimberly Milosh
Joseph J. Barry
Norman J. Greenfield

UBOC
Desta Gebre-Medhin-Huff

US Bancorp
Kevin Storm

Wachovia
Avery Wise

Federal Reserve System
Barbara Bouchard
Bill Bassett
Stacy Coleman
Fang Du
Donald Gabbai
Anna Lee Hewko
David Jones
Christopher Laursen
David Lynch
David Palmer
Mark Van DerWeide
Coryann Stefansson (New York)
Amanda G. Allen (New York)
William Lang (Philadelphia)
Paul Huck (Chicago)
Timothy DeRosier (San Francisco)
Kristen Leblond (San Francisco)
Kimberly DeTrask (Boston-Calling in)

FDIC
Jason Cave
Bob Bean
Tracy Fitzgerald
Ben McDonough
Mike Phillips
Mark S. Schmidt

OCC
Fred Finke
Tommy Snow
Kevin Bailey
Joe Evers
Mark Odell
Amrit Sekhon
Mitch Stengel

OTS
David Tate
Roberta Renz
David Riley
Austin Hong
Eric Hirschhorn
Sonja White
Fred Phillips-Patrick