

This suggests a positive correlation between observed default frequencies and observed loss rates on defaulted loans, with both declining during periods of favorable economic conditions and both increasing during unfavorable economic periods. While cyclicity in LGDs may be significant for a number of lending activities, the Agencies believe that cyclicity is likely to be the norm for SL portfolios, and that a banking organization's procedures for estimating LGD inputs for SL exposures should assess and quantify this cyclicity in a comprehensive and systematic fashion.

The Agencies invite comment on ways to deal with cyclicity in LGDs. How can risk sensitivity be achieved without creating undue burden?

For core and opt-in banks that may not be able to provide sufficiently reliable estimates of PD, LGD, and M for each SL exposure, the New Accord offers a Supervisory Slotting Criteria (SSC) approach. Under this approach, rather than estimating the loan-level risk parameters, banking organizations would use slotting criteria to map their internal risk rating grades to one of five supervisory rating grades: Strong, Good, Satisfactory, Weak, and Default. In

addition, supervisory risk weights would be assigned to each of these supervisory rating grades. To assist banking organizations in implementing these supervisory rating grades, for reference purposes the New Accord associates each with an explicit range of external rating grades. If the SSC approach were allowed in the United States, the Agencies would have to develop slotting criteria that would take into account factors such as market conditions; financial ratios such as debt service coverage or loan-to-value ratios; cash flow predictability; strength of sponsor or developer; and other factors likely to affect the PD and/or LGD of each loan.

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 rating grades to supervisory rating grades if the SSC approach were to be adopted in the United States.

Under the A-IRB approach, a banking organization would estimate the risk inputs for each SL exposure and then calculate the A-IRB capital charge for the exposure by substituting the estimated PD, LGD, EAD, and M into

one of two risk weight functions. The first risk weight function is the wholesale risk weight function and applies to all PF, OF, and CF exposures, as well as to all low-asset-correlation CRE exposures (including in-place commercial properties). The second risk weight function applies to all HVCRE exposures. It also is the same as the wholesale risk weight function, except that it incorporates a higher asset correlation parameter. The asset correlation equation for HVCRE is as follows:

$$R = 0.12 \times (1 - \text{EXP}(-50 \times \text{PD})) + 0.30 \times [\text{EXP}(-50 \times \text{PD})]$$

Where

R denotes asset correlation;

EXP denotes the natural exponential function; and

PD denotes probability of default.

The following table presents the A-IRB capital requirement (K) for a range of values of both PD and M. In this table, LGD is assumed to equal 45 percent. This LGD is used for consistency with the similar table above for wholesale exposures and should not be construed as an indication that 45 percent is a typical LGD for HVCRE exposures.

#### HVCRE CAPITAL REQUIREMENTS

[In percentage points]

PD	Effective remaining maturity		
	1 year	3 years	5 years
0.05 percent .....	1.24	2.46	3.68
0.10 percent .....	2.05	3.61	5.16
0.25 percent .....	3.74	5.76	7.77
0.50 percent .....	5.52	7.79	10.07
1.00 percent .....	7.53	9.89	12.25
2.00 percent .....	9.55	11.79	14.02
5.00 percent .....	13.12	15.12	17.11
10.00 percent .....	18.59	20.54	22.49
20.00 percent .....	26.84	28.65	30.47

All ADC loans would be treated as HVCRE exposures, unless the borrower has "substantial equity" at risk or the property is pre-sold or sufficiently pre-leased. In part, this reflects some empirical evidence suggesting that most ADC loans have relatively high asset correlations. It also, however, reflects a longstanding supervisory concern that CRE lending to finance speculative construction and development is vulnerable to, and may worsen, speculative swings in CRE markets, especially when there is little borrower equity at risk. Such lending was a major factor causing the stress experienced by many banks in the early 1990s, not only

in the United States but in other countries as well.

Under the New Accord, SL loans financing the construction of one- to four-family residential properties (single or in subdivisions) are included with other ADC loans in the high asset correlation category. However, loans financing the construction of pre-sold one- to four-family residential properties would be eligible to be treated as low-asset-correlation CRE exposures. In some cases the loans may finance the construction of subdivisions or other groups of houses, some of which are pre-sold while others are not.

Under the New Accord, each national supervisory authority is directed to

recognize and incorporate into its implementation of the New Accord the high asset correlation determinations of other national supervisory authorities for loans made in their respective jurisdictions. Thus, when the Agencies designate certain CRE properties as HVCRE, foreign banking organizations making extensions of credit to those properties also would be expected to treat them as HVCRE. Similarly, when non-U.S. supervisory authorities designate certain CRE as HVCRE, U.S. banking organizations that extend credit to those properties would be expected to treat them as HVCRE.