

exposures, the retail A-IRB framework is intended to provide banking organizations with substantial flexibility to use the retail portfolio segmentation that they believe is most appropriate for their activities. In determining how to group their retail exposures within each sub-category into portfolio segments for the purpose of assigning A-IRB risk inputs, the Agencies believe that banking organizations should use a segmentation approach that is consistent with their approach for internal risk assessment purposes and that classifies exposures according to predominant risk characteristics.

As general principles for segmentation, banking organizations should group exposures in each of the three retail sub-categories into portfolios or pools according to the sub-category's principal risk drivers, and would have to be able to demonstrate that the resultant segmentation effectively differentiates and rank orders risk and provides reasonably accurate and consistent quantitative estimates of PD, LGD, and EAD. With the exceptions noted below, the Agencies are not proposing that institutions must consider any particular risk drivers or employ any minimum number of portfolios or pools in any of the three retail sub-categories. The only specific limitations that the Agencies would propose in regard to the portfolio segmentation of retail exposures are (1) banking organizations generally would not be permitted to combine retail exposures from multiple countries into the same portfolio segment (because of differences in national legal systems and bankruptcy regimes), and (2) banking organizations would need to separately segment delinquent retail exposures.

The inputs to the retail A-IRB capital formulas differ slightly from the inputs to the wholesale A-IRB capital formulas. Measures of PD, LGD, and EAD remain important elements, but there is no M input to the retail A-IRB capital formulas. Rather, the retail A-IRB capital formulas implicitly incorporate average maturity effects in general, such as in the residential mortgage sub-category.

Aside from the applicable definition of default, discussed below, the definitions of PD, LGD, and EAD for retail exposures are generally equivalent to those for wholesale exposures. One additional element of potential flexibility for banking organizations in the retail context needs to be highlighted. The Agencies recognize that certain banking organizations that may qualify for the advanced approaches segment their retail portfolios for management purposes by

EL, rather than by separately measuring PD and LGD, as required under the A-IRB framework. Therefore, the Agencies propose that banking organizations be permitted substantial flexibility in translating measures of EL into the requisite PD and LGD inputs. For non-revolving portfolio segments, EL generally would equal the product of PD and LGD, so that if a banking organization has an estimate of EL and either PD or LGD, it would be able to infer an estimate of the other required input.

In addition, the Agencies are proposing that if one or the other of PD and LGD did not tend to vary significantly across portfolio segments, the banking organization would be permitted to apply a general estimate of that input to multiple segments and to use that general estimate, together with segment-specific estimates of EL, to infer segment-specific estimates of the other required input. The Agencies note, however, that this proposal offers substantial flexibility to institutions and may, in fact, be overly flexible (for example, because LGDs on residential mortgages tend to be quite cyclical). For these loans, the above method of inferring PDs or LGDs from a long-run average EL would not necessarily result in PD being estimated as a long-run average, and LGD would not necessarily reflect the loss rate expected to prevail when default rates are high. Banking organizations using an EL approach to retail portfolio segmentation would have to ensure that the A-IRB capital requirement under this method is at least as conservative as a PD/LGD method in order to minimize any potential divergences between capital requirements computed under the PD/LGD approach versus an EL approach.

As in the wholesale A-IRB framework, a floor of 3 basis points (0.03 percent) applies to the PD estimates for all retail exposures (that is, the minimum PD is 3 basis points). In addition, for residential mortgage exposures other than those guaranteed by a sovereign government, a floor of 10 percent on the LGD estimate would apply, based on the view that LGDs during periods of high default rates are unlikely to fall below this level if measured appropriately. Along with the overall monitoring of the implementation of the advanced approaches and the determination whether to generally relax the floors established during the initial implementation phases (that is, the 90 and 80 percent floors discussed above), the Agencies intend to review the need to retain PD and LGD floors for retail exposures following the first two years

of implementation of the A-IRB framework.

The Agencies are proposing the following data requirements for retail A-IRB. Banking organizations would have to have a minimum of five years of data history for PD, LGD, and EAD, and preferably longer periods so as to include a complete economic cycle. Banking organizations would not have to give equal weight to all historical factors if they can demonstrate that the more recent data are better predictors of the risk inputs. Also, banking organizations would have to have a minimum of three years of experience with their portfolio segmentation and risk management systems.

Definition of Default and Loss

The retail definition of default and loss being proposed by the Agencies differs significantly from that proposed for the wholesale portfolio. Specifically, the Agencies propose to use the definitions of loss recognition embodied in the Federal Financial Institutions Examination Council (FFIEC) Uniform Retail Credit Classification and Account Management Policy.²¹ All residential mortgages and all revolving credits would be charged off, or charged down to the value of the property, after a maximum of 180 days past due; other credits would be charged off after a maximum of 120 days past due.

In addition, the Agencies are proposing to define a retail default to include the occurrence of any one of the three following events if it occurs prior to the respective 120- or 180-day FFIEC policy trigger: (1) A full or partial charge-off resulting from a significant decline in credit quality of the exposure; (2) a distressed restructuring or workout involving forbearance and loan modification; or (3) a notification that the obligor has sought or been placed in bankruptcy. Finally, for retail exposures (as opposed to wholesale exposures) the definition of default may be applied to a particular facility, rather than to the obligor. That is, default on one obligation would not require a banking organization to treat all other obligations of the same obligor as defaulted.

Undrawn Lines

The treatment of undrawn lines of credit, in particular those associated with credit cards, merits specific discussion. Banking organizations would be permitted to incorporate undrawn retail lines in one of two ways. First, banking organizations could

²¹ The FFIEC Uniform Retail Credit Classification and Account Management Policy was issued on June 12, 2000. It is available on the FFIEC Web site at www.FFIEC.gov.