

incorporate them into their EAD estimates directly, by assessing the likelihood that undrawn balances would be drawn at the time of an event of default. Second, banking organizations could incorporate them into LGD estimates by assessing the size of potential losses in default (including those arising from both currently drawn and undrawn balances) as a proportion of the current drawn balance. In the latter case, it is possible that the relevant LGD estimates would exceed 100 percent. While the proposed EAD approach for undrawn wholesale and retail lines is the same, the Agencies are aware that the sheer volume of credit card undrawn lines and the ratio of undrawn lines to outstanding balances create issues for undrawn retail lines that differ from undrawn wholesale lines not only in degree but also in kind.

An additional issue arises in connection with the undrawn lines associated with credit card accounts whose drawn balances (but not undrawn balances) have been securitized. To the extent that banking organizations remain exposed to the risk that such undrawn lines will be drawn, but such undrawn lines are not themselves securitized, then there is a need for institutions to hold regulatory capital against such undrawn lines. The Agencies propose that a banking organization would be required to hold capital against the full amount of any undrawn lines regardless of whether drawn amounts are securitized. This presumes that the institution itself is exposed to the credit risk associated with future draws.

The Agencies are interested in comments and specific proposals concerning methods for incorporating undrawn credit card lines that are consistent with the risk characteristics and loss and default histories of this line of business.

The Agencies are interested in further information on market practices in this regard, in particular the extent to which banking organizations remain exposed to risks associated with such accounts. More broadly, the Agencies recognize that undrawn credit card lines are significant in both of the contexts discussed above, and are particularly interested in views on the appropriate retail A-IRB treatment of such exposures.

#### Future Margin Income

In the New Accord, the retail A-IRB treatment of QREs includes a unique additional input that arises because of the large amount of expected losses typically associated with QREs. As noted above, the A-IRB approach would require banking organizations to hold regulatory capital against both EL and UL. Banking organizations typically

seek to cover expected losses through interest income and fees for all of their business activities, and the Agencies recognize that this practice is a particularly important aspect of the business model for QREs.

The Agencies are including in this proposal, for the QRE sub-category only, that future margin income (FMI) be permitted to offset a portion of the A-IRB retail capital charge relating to EL. For this purpose, the Agencies propose to define the amount of eligible FMI for the QRE sub-category as the amount of income anticipated to be generated by the relevant exposures over the next twelve months that can reasonably be assumed to be available to cover potential credit losses on the exposures after covering expected business expenses, and after subtracting a cushion to account for potential volatility in credit losses (UL). FMI would not be permitted to include anticipated income from new accounts and would have to incorporate assumptions about income from existing accounts that are in line with the banking organization's historical experience. The amount of the cushion to account for potential volatility in credit losses would be set equal to two standard deviations of the banking organization's annualized loss rate on the exposures. The Agencies would expect banking organizations to be able to support their estimates of eligible FMI on the basis of historical data and would disallow the use of FMI in the QRE capital formula if this is not the case. The step needed to recognize eligible FMI is discussed below.

Permitting a FMI offset to the A-IRB capital requirement for QREs could have a significant impact on the level of minimum regulatory capital at institutions adopting the advanced approaches. The Agencies would need to fully assess and analyze the impact of such an FMI offset on institutions' risk-based capital ratios prior to final implementation of the A-IRB approach. Furthermore, the Agencies anticipate the need to issue additional guidance setting out more specific expectations in this regard.

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 EL by demonstrating that their anticipated FMI for this sub-category is likely to more than sufficiently cover EL over the next year.

The Agencies are seeking comment on the proposed definitions of the retail A-IRB exposure category and sub-categories. Do the proposed categories provide a reasonable balance between the need for differential treatment to achieve risk-sensitivity and the

desire to avoid excessive complexity in the retail A-IRB framework? What are views on the proposed approach to inclusion of SMEs in the other retail category?

The Agencies are also seeking views on the proposed approach to defining the risk inputs for the retail A-IRB framework. Is the proposed degree of flexibility in their calculation, including the application of specific floors, appropriate? What are views on the issues associated with undrawn retail lines of credit described here and on the proposed incorporation of FMI in the QRE capital determination process?

The Agencies are seeking comment on the minimum time requirements for data history and experience with portfolio segmentation and risk management systems: Are these time requirements appropriate during the transition period? Describe any reasons for not being able to meet the time requirements.

#### Retail Exposures: Formulas

The retail A-IRB capital formulas are very similar to the wholesale A-IRB formulas, and are based on the same underlying concepts. However, because there is no M adjustment associated with the retail A-IRB framework, the retail A-IRB capital calculations generally involve fewer steps than the wholesale A-IRB capital calculations. As with the wholesale A-IRB framework, the output of the retail A-IRB formulas is a minimum capital requirement, expressed in dollars, for the relevant pool of exposures. The capital requirement would be converted into an equivalent amount of risk-weighted assets by multiplying the capital requirement by 12.5. The two key steps in implementing the retail A-IRB capital formulas are (1) assessing the relevant asset correlation parameter, and (2) calculating the minimum capital requirement for the relevant pool of exposures.

#### Residential Mortgages and Related Exposures

For residential mortgage and related exposures, the retail A-IRB capital formula requires only one step. This is because the asset correlation parameter for such exposures is fixed at 15 percent, regardless of the PD of any particular pool of exposures. The fixed asset correlation parameter reflects the Agencies' view that the arguments for linking the asset correlation to PD, as occurs in the wholesale A-IRB framework and in the other two sub-categories of retail exposures, are not as relevant for residential mortgage-related exposures, whose performance is significantly influenced by broader trends in the housing market for borrowers of all credit qualities. The assumed asset correlation of 15 percent also seeks implicitly to reflect the higher average maturity associated with