

CAPITAL REQUIREMENTS—Continued
[In percentage points]

PD	LGD		
	25 percent	50 percent	75 percent
0.10 percent	0.56	1.11	1.67
0.25 percent	1.06	2.13	3.19
0.50 percent	1.64	3.28	4.92
1.00 percent	2.35	4.70	7.05
2.00 percent	3.08	6.15	9.23
5.00 percent	3.94	7.87	11.81
10.00 percent	5.24	10.48	15.73
20.00 percent	8.55	17.10	25.64

Subject to the qualifications described earlier, QIS3 estimated a 25 percent reduction in credit risk-based capital requirements for the other retail category.

The Agencies are seeking comment on the retail A-IRB capital formulas and the resulting capital requirements, including the specific issues mentioned. Are there particular retail product lines or retail activities for which the resulting A-IRB capital requirements would not be appropriate, either because of a misalignment with underlying risks or because of other potential consequences?

A-IRB: Other Considerations

As described earlier, the A-IRB capital requirement includes components to cover both EL and UL. Because banking organizations have resources other than capital to cover EL, the Agencies propose to recognize certain of these measures as potential offsets to the A-IRB capital requirement, subject to the limitations set forth below. The use of eligible FMI for QREs is one such potential mechanism that has already been discussed.

Loan Loss Reserves

A second important mechanism involves the allowance for loan and lease losses (ALLL), also referred to as general loan loss reserves. Under the general risk-based capital rules, an amount of the ALLL is eligible for inclusion as an element of Tier 2 capital, up to a limit equal to 1.25 percent of gross risk-weighted assets. Loan loss reserves above this limit are deducted from risk-weighted assets, on a dollar-for-dollar basis. The New Accord proposes to retain the 1.25 percent limit on the eligibility of loan loss reserves as an element of Tier 2 capital. However, the New Accord also contains, and the Agencies are proposing for comment, a feature that would allow the amount of the ALLL (net of associated deferred tax) above this 1.25 percent limit to be used to

offset the EL portion of A-IRB capital requirements in certain circumstances.

The offset would be limited to that amount of EL that exceeds the 1.25 percent limit. For example, if the 1.25 percent limit equals \$100, the ALLL equals \$125, and the EL portion of the A-IRB capital requirement equals \$110, then \$10 of the capital requirement may be directly offset (\$110 – \$100). The additional amount of the ALLL not included in Tier 2 capital and not included as a direct offset against the A-IRB capital requirement (\$125 – \$110 = \$15 in the example) would continue to be deducted from risk-weighted assets.

It is important to recognize that this treatment would likely result in a significantly more favorable treatment of such excess ALLL amounts than simply deducting them from risk-weighted assets. Under the proposal, banking organizations would be allowed to multiply the eligible excess ALLL by a factor of 12.5 because the minimum total capital requirement is 8 percent of risk-weighted assets. In effect, this treatment is 12.5 times more favorable than the treatment contained in the general risk-based capital rules, which allow only a deduction against risk-weighted assets on a dollar-for-dollar basis. In addition, it is important to note that a dollar-for-dollar offset against the A-IRB capital requirement is also more favorable than the inclusion of ALLL below the 1.25 percent limit in Tier 2 capital, because the latter has no impact on Tier 1 capital ratios, while the former does.

The Agencies recognize the existence of various issues in regard to the proposed treatment of ALLL amounts in excess of the 1.25 percent limit and are interested in views on these subjects, as well as related issues concerning the incorporation of expected losses in the A-IRB framework and the treatment of the ALLL generally. Specifically, the Agencies invite comment on the domestic competitive impact of the potential difference in the treatment of reserves described above.

Another issue the Agencies wish to highlight is the inclusion within the New Accord of the ability for banking organizations to make use of “general specific” provisions as a direct offset against EL capital requirements. Such provisions are not specific to particular exposures but are specific to particular categories of exposures and are not allowed as an element of Tier 2 capital. While several other countries make use of such provisions, the Agencies do not believe existing elements of the ALLL in the United States qualify for such treatment.

The Agencies seek views on this issue, including whether the proposed U.S. treatment has significant competitive implications. Feedback also is sought on whether there is an inconsistency in the treatment of general specific provisions (all of which may be used as an offset against the EL portion of the A-IRB capital requirement) in comparison to the treatment of the ALLL (for which only those amounts of general reserves exceeding the 1.25 percent limit may be used to offset the EL capital charge).

Charge-Offs

Another potential offset to the EL portion of the A-IRB capital requirements is the use of partial charge-offs, where a portion of an individual exposure is written off. Given the A-IRB definition of default, a partial charge-off would cause an exposure to be classified as a defaulted exposure (that is, PD=100%), in which case the A-IRB capital formulas ensure that the resulting capital requirement on the defaulted exposure is equal to EAD * LGD, where EAD is defined as the gross exposure amount prior to the partial charge-off. All of this capital requirement can be considered to be covering EL.

The New Accord proposes that for such partially charged-off exposures, the banking organization be allowed to use the amount of the partial charge-off to offset the EL component of that asset's capital charge on a dollar-for-dollar basis. In addition, to the extent that the