

partial charge-off on a defaulted exposure exceeds the EL capital charge on that exposure, the amount of this surplus could be used to offset the EL capital charges on other defaulted assets in the same portfolio (for example, corporates, banks, residential mortgages, etc.), but not for any other purpose.

An implication of this aspect of the New Accord is that if a defaulted loan's charge-off were at least equal to its expected loss, no additional capital requirement would be incurred on that exposure. For example, consider a \$100 defaulted exposure having an LGD of 40 percent, implying an expected loss of \$40, equal to the IRB capital charge. If the charge-off were equal to \$40, under the New Accord approach, there would be no additional capital required against the resultant \$60 net position. The Agencies do not believe this is a prudent or acceptable outcome, since this position is not riskless and a banking organization could be forced to recognize additional charge-offs if the recoveries turn out to be less than expected.

To prevent this possibility, the Agencies propose that, for defaulted exposures, the A-IRB capital charge (inclusive of any EL offsets for charge-offs) be calculated as the sum of (a) EAD * LGD less any charge-offs and (b) 8 percent of the carrying value of the loan (that is, the gross exposure amount (EAD) less any charge-offs).

Also, the charged off amounts in excess of the EAD * LGD product would not be permitted to offset the EL capital requirements for other exposures. In effect, the proposed A-IRB capital charge on a defaulted exposure adds a buffer for defaulted assets and results in a floor equal to 8 percent of the remaining book value of the exposure if the banking organization has taken a charge-off equal to or greater than the EAD * LGD. Importantly, this treatment would not apply to a defaulted exposure that has been restructured and where the obligor has not yet defaulted on the restructured credit. Upon any restructuring, whether associated with a default or otherwise, the A-IRB capital charge would be based on the EAD, PD, LGD, and M applicable to the exposure after it has been restructured. The existence of any partial charge-offs associated with the pre-restructured credit would affect the A-IRB capital charge on the restructured exposure only through its impact on the post-restructured exposure's EAD, PD, and/or LGD.

Purchased Receivables

This section describes the A-IRB treatment for wholesale and retail credit

exposures acquired from another institution (purchased receivables). The purchase of such receivables may expose the acquiring banking organization to potential losses from two sources: credit losses attributable to defaults by the underlying receivables obligors, and losses attributable to dilution of the underlying receivables.²² The total A-IRB capital requirement for purchased receivables would be the sum of (a) a capital charge for credit risk, and (b) a separate capital charge for dilution risk, when dilution is a material factor.

Capital Charge for Credit Risk

The New Accord's proposed treatment of purchased loans would treat a purchase discount as equivalent to a partial charge-off, and for this reason it could imply a zero capital charge against certain exposures. In general, a zero capital charge would emerge whenever the difference between a loan's face value and purchase price (the purchase discount) was greater than or equal to its LGD, as might be the case with a secondary market purchase of deeply distressed debt. Again, the Agencies believe that a zero capital charge in such a circumstance is unwarranted because the position is not riskless.

The Agencies propose that for a credit exposure that is purchased or acquired from another party, the A-IRB capital charge would be calculated as if the exposure were a direct loan to the underlying obligor in the amount of the loan's carrying value to the purchasing banking organization with other attributes of the loan agreement (for example, maturity, collateral, covenants) and, hence, LGD, remaining unchanged. This treatment would apply regardless of whether the carrying value to the purchasing banking organization was less than, equal to, or greater than the underlying instrument's face value. Thus, if a loan having a principal amount equal to \$100 and associated PD and LGD of 10 percent and 40 percent was purchased for \$80, the capital charge against the purchased loan would be calculated as if that loan had an EAD equal to \$80, PD equal to 10 percent, and LGD equal to 40 percent.

In general, the same treatment would apply to pools of purchased receivables.

²² Dilution refers to the possibility that the contractual amounts payable by the receivables obligors may be reduced through future cash or non-cash credits to the accounts of these obligors. Examples include offsets or allowances arising from returns of goods sold, disputes regarding product quality, possible debts of the originator/seller to a receivables obligor, and any payment or promotional discounts offered by the originator/seller (for example, a credit for cash payments within 30 days).

However, under the conditions detailed below, an alternative top-down approach (similar to that used for retail exposures) may be applied to pools of purchased receivables if the purchasing banking organization can only estimate inputs to the capital function (PD, LGD, EAD, and M) on a pool or aggregate basis.

Top-Down Method for Pools of Purchased Receivables

Under the top-down approach, required capital would be determined using the appropriate A-IRB capital formula (that is, for wholesale exposures, the wholesale capital function, and for retail exposures, the appropriate retail capital function) in combination with estimates of PD, LGD, EAD, and M developed for pools of receivables. In estimating the pool parameters, the banking organization first would determine EL for the purchased receivables pool, expressed (in decimal form) at an annual rate relative to the amount currently owed to the banking organization by the obligors in the receivables pool. The estimated EL would not take into account any assumptions of recourse or guarantees from the seller of the receivables or other parties. If the banking organization can decompose EL into PD and LGD components, then it would do so and use those components as inputs into the capital function. If the institution cannot decompose EL, then it would use the following split: PD would equal the estimated EL, and LGD would be 100 percent. Under the top-down approach, EAD would equal the carrying amount of the receivables and for wholesale exposures, M would equal the exposure-weighted average effective maturity of the receivables in the pool.²³

Treatment of Undrawn Receivables Purchase Commitments

Capital charges against any undrawn portions of receivables purchase facilities ('undrawn purchase commitments') also would be calculated using the top-down methodology. The EL (and/or PD and LGD) parameters would be determined on the basis of the current pool of eligible receivables using the pool-level estimation methods described above. For undrawn commitments under revolving purchase facilities, the New Accord specifies that the EAD would be set at 75 percent of the undrawn line. This treatment reflects a concern that relevant

²³ If a banking organization can estimate the exposure-weighted average size of the pool it also would use the firm-size adjustment (S) in the wholesale framework.