

historical data for estimating such EADs reliably is not available at many banking organizations. For other undrawn purchase commitments, EAD would be estimated by the banking organization providing the facility and would be subject to the same operational standards that are applicable to undrawn wholesale credit lines. The level of M associated with undrawn purchase commitments would be the average effective maturity of receivables eligible for purchase from that seller, so long as the facility contains effective arrangements for protecting the banking organization against an unanticipated deterioration. In the absence of such protections, the M for an undrawn commitment would be calculated as the sum of (a) the longest-dated potential receivable under the purchase agreement, and (b) the remaining maturity of the facility.

The Agencies seek comment on the proposed methods for calculating credit risk capital charges for purchased receivables. Are the proposals reasonable and practicable?

For committed revolving purchase facilities, is the assumption of a fixed 75 percent conversion factor for undrawn lines reasonable? Do banking organizations have the ability (including relevant data) to develop their own estimate of EADs for such facilities? Should banking organizations be permitted to employ their own estimated EADs, subject to supervisory approval?

A banking organization may only use the top-down approach with approval of its primary Federal supervisor. In addition, the purchased receivables would have to have been purchased from unrelated, third party sellers and the organization may not have originated the credit exposures either directly or indirectly. The receivables must have been generated on an arm's length basis between the seller and the obligor (intercompany accounts receivable and receivables subject to contra-accounts between firms that buy and sell to each other would not qualify). Also, the receivables may not have a remaining maturity of greater than one year, unless they are fully secured. The Agencies propose that the bottom-up method would have to be used for receivables to any single obligor, or to any group of related obligors, that aggregate to more than \$1 million.

#### Capital Charge for Dilution Risk

When dilution is a material risk factor,<sup>24</sup> purchased receivables would be subject to a separate capital charge for that risk. The dilution capital charge

may be calculated at the level of each individual receivable and then aggregated, or, for a pool of receivables, at the level of the pool as a whole. The capital charge for dilution risk would be calculated using the wholesale A-IRB formula and the following parameters: EAD would be equal to the gross amount of receivable(s) balance(s); LGD would be 100 percent; M would be the (exposure weighted-average) effective remaining maturity of the exposure(s); and PD would be the expected dilution loss rate, defined as total expected dilution losses over the remaining term of the receivable(s) divided by EAD.<sup>25</sup> Expected dilution losses would be computed on a stand-alone basis; that is, under the assumption of no recourse or other support from the seller or third-party guarantors.

The following table illustrates the dilution risk capital charges (per dollar of EAD) implied by this approach for a hypothetical pool of purchased receivables having a remaining maturity of one year or less. As can be seen, the proposal implies capital charges for dilution risk that are many multiples of expected dilution losses.

#### CAPITAL REQUIREMENTS

[In percentage points]

Expected dilution loss rate	Dilution risk capital charge (per dollar of EAD, percent)
0.05 percent .....	2.05
0.10 percent .....	3.42
0.25 percent .....	6.41
0.50 percent .....	9.77
1.00 percent .....	14.03
2.00 percent .....	19.03
5.00 percent .....	28.45
10.00 percent .....	41.24

The Agencies seek comment on the proposed methods for calculating dilution risk capital requirements. Does this methodology produce capital charges for dilution risk that seem reasonable in light of available historical evidence? Is the wholesale A-IRB capital formula appropriate for computing capital charges for dilution risk?

In particular, is it reasonable to attribute the same asset correlations to dilution risk as are used in quantifying the credit risks of wholesale exposures within the A-IRB framework? Are there alternative method(s) for determining capital charges for dilution risk that would be superior to that set forth above?

#### Minimum Requirements

The Agencies propose to apply standards for the estimation of risk

inputs and expected dilution losses and for the control and risk management systems associated with purchased receivables programs that are consistent with the general guidance contained in the New Accord. These standards will aim to ensure that risk input and expected dilution loss estimates are reliable and consistent over time, and reflect all relevant information that is available to the acquiring banking organization. The minimum operational requirements are intended to ensure that the acquiring banking organization has a valid legal claim to cash proceeds generated by the receivables pool, that the pool and cash proceeds are closely monitored and controlled, and that systems are in place to identify and address seller, servicer, and other potential risks. A more detailed discussion of these requirements will be provided when the Agencies release draft examination guidance dealing with purchased receivables programs.

The Agencies seek comment on the appropriate eligibility requirements for using the top-down method. Are the proposed eligibility requirements, including the \$1 million limit for any single obligor, reasonable and sufficient?

The Agencies seek comment on the appropriate requirements for estimating expected dilution losses. Is the guidance set forth in the New Accord reasonable and sufficient?

#### Risk Mitigation

For purposes of reducing the capital charges for credit risk or dilution risk with respect to purchased receivables, purchase discounts, guarantees, and other risk mitigants may be recognized through the same framework used elsewhere in the A-IRB approach.

#### Credit Risk Mitigation Techniques

The New Accord takes account of the risk-mitigating effects of both financial and nonfinancial collateral, as well as guarantees, including credit derivatives. For these risk mitigants to be recognized for regulatory capital purposes, the banking organization must have in place operational procedures and risk management processes that ensure that all documentation used in collateralizing or guaranteeing a transaction is binding on all parties and legally enforceable in all relevant jurisdictions. The banking organization must have conducted sufficient legal review to verify this conclusion, must have a well-founded legal basis for the conclusion, and must reconduct such a review as necessary to ensure continuing enforceability.

<sup>24</sup> If dilution risk is immaterial there would be no additional capital charge.

<sup>25</sup> If the remaining term exceeds one year, the expected dilution loss rate would be specified at an annual rate.