

obligation to the banking group. Overdrafts will be considered as being past due once the customer has breached an advised limit or been advised of a limit smaller than current outstandings.

- The bank considers that the obligor is unlikely to pay its credit obligations to the banking group in full, without recourse by the bank to actions such as liquidating collateral (if held).

Any obligor (or its underlying credit facilities) that meets one or more of the following conditions is considered unlikely to pay and therefore in default:

- The bank puts the credit obligation on non-accrual status.
- The bank makes a charge-off or account-specific provision resulting from a significant perceived decline in credit quality subsequent to the bank taking on the exposure.
- The bank sells the credit obligation at a material credit-related economic loss.
- The bank consents to a distressed restructuring of the credit obligation where this is likely to result in a diminished financial obligation caused by the material forgiveness, or postponement, of principal, interest or (where relevant) fees.
- The bank has filed for the obligor's bankruptcy or a similar order in respect of the obligor's credit obligation to the banking group.
- The obligor has sought or has been placed in bankruptcy or similar protection where this would avoid or delay repayment of the credit obligation to the banking group.

While most conditions of default currently are identified by bank reporting systems, institutions will need to augment data capture systems to collect those default circumstances that may not have been traditionally identified. These include facilities that are current and still accruing but where the obligor declared or was placed in bankruptcy. They must also capture so called "silent defaults"—defaults when the loss on a facility was avoided by liquidating collateral.

Loan sales on which a bank experiences a material loss due to credit deterioration are considered a default. Material credit related losses are defined as XX. (The agencies seek comment on how to define "material" loss in the case of loans sold at a discount). Banks should ensure that they have adequate systems to identify such transactions and to maintain adequate records so that reviewers can assess the adequacy of the institution's decision-making process in this area.

Obligor Ratings

S. Banks must assign discrete obligor grades.

While banks may use models to estimate probabilities of default for individual obligors, the IRB approach requires banks to group the obligors into discrete grades. Each obligor grade, in turn, must be associated with a single PD.

S. The obligor-rating system must result in a ranking of obligors by likelihood of default.

The proper operation of the obligor-rating system will feature a ranking of obligors by likelihood of default. For example, if a bank uses a rating system based on a 10-point scale, with 1 representing obligors of highest financial strength and 10 representing defaulted obligors, grades 2 through 9 should represent groups of ever-increasing risk. In a rating system in which risk increases with the grade, an obligor with a grade 4 is riskier than an obligor with a grade 2, but need not be twice as risky.

S. Separate exposures to the same obligor must be assigned to the same obligor rating grade.

As noted above, the IRB framework requires that the obligor rating be distinct from the loss severity rating, which is assigned to the facility. Collateral and other facility characteristics should not influence the obligor rating. For example, in a 1-to-10 rating system, where risk increases with the number grade, a defaulted borrower with a fully cash-secured transaction should be rated a 10—defaulted—regardless of the remote expectation of loss. Likewise, a borrower whose financial condition warrants the highest investment grade rating should be rated a 1 even if the bank's transactions are subordinate to other creditors and unsecured. Since the rating is assigned to the obligor and not the facility, separate exposures to the same obligor must be assigned to the same obligor rating grade.

At the bottom of any IRB system rating scale is a default grade. Once an obligor is considered to be in default for IRB purposes, that obligor must be assigned a default grade until such time as its financial condition and performance improve sufficiently to clearly meet the bank's internal rating definition for one of its non-default grades. Once an obligor is in default on any material credit obligation to the subject bank, all of its facilities at that institution are considered to be in default.

S. In assigning an obligor to a rating category, the bank must assess the risk

of obligor default over a period of at least one year.

S. Obligor ratings must reflect the impact of financial distress.

In assigning an obligor to a rating category, the bank must assess the risk of obligor default over a period of at least one year. This use of a one-year assessment horizon does not mean that a bank should limit its consideration to outcomes for that obligor that are most likely over that year; the rating must take into account possible adverse events that might increase an obligor's likelihood of default.

Rating Philosophy—Decisions Underlying Ratings Architecture

S. Banks must adopt a ratings philosophy. Policy guidelines should describe the ratings philosophy, particularly how quickly ratings are expected to migrate in response to economic cycles.

S. A bank's capital management policy must be consistent with its ratings philosophy in order to avoid capital shortfalls in times of systematic economic stress.

In the IRB framework, banks assign obligors to groups that are expected to share common default frequencies. That general description, however, still leaves open different possible implementations, depending on how the bank defines the set of possible adverse events that the obligor might face. A bank must decide whether obligors are grouped by expected common default frequency over the next year (a so-called point-in-time rating system) or by an expected common default frequency over a wider range of possible stress outcomes (a so-called through-the-cycle rating system). Choosing between a point-in-time system and a through-the-cycle system yields a rating philosophy.

In point in time rating systems, obligors are assigned to groups that are expected to share a common default frequency in a particular year. Point-in-time ratings change from year to year as borrowers' circumstances change, including changes due to the economic possibilities faced by the borrowers. Since the economic circumstances of many borrowers reflect the common impact of the general economic environment, the transitions in point-in-time ratings will reflect that systematic influence. A Merton-style probability of default prediction model is commonly believed to be an example of a point-in-time approach to rating (although that may depend on the specific implementation of the model).

Through-the-cycle rating systems do not ask the question, what is the probability of default over the next year.