

Instead, they assign obligors to groups that would be expected to share a common default frequency if the borrowers in them were to experience distress, regardless of whether that distress is in the next year. Thus, as the descriptive title suggests, this rating philosophy abstracts from the near-term economic possibilities and considers a richer assessment of the possibilities. Like point-in-time ratings, through the cycle ratings will change from year to year due to changes in borrower circumstance. However, since this rating philosophy abstracts from the immediate economic circumstance and considers the implications of hypothetical stress circumstances, year to year transitions in ratings will be less influenced by changes in the actual economic environment. The ratings agencies are commonly believed to use through-the-cycle rating approaches.

Current practice in many banks in the U.S. is to rate obligors using an approach that combines aspects of both point-in-time and through the cycle approaches. The explanation provided by banks that combine those approaches is that they want rating transitions to reflect the directional impact of changes in the economic environment, but that they do not want all of the volatility in ratings associated with a point-in-time approach.

Regardless of which ratings philosophy a bank chooses, an IRB bank must articulate clearly its approach and the implications of that choice. As part of the choice of rating philosophy, the bank must decide whether the same ratings philosophy will be employed for all of the bank's portfolios. And management must articulate the implications that the bank's ratings philosophy has on the bank's capital planning process. If a bank chooses a ratings philosophy that is likely to result in ratings transitions that reflect the impact of the economic cycle, its capital management policy must be designed to avoid capital shortfalls in times of systematic economic stress.

Obligor-Rating Granularity

S. An institution must have at least seven obligor grades that contain only non-defaulted borrowers and at least one grade to which only defaulted borrowers are assigned.

The number of grades used in a rating system should be sufficient to reasonably ensure that management can meaningfully differentiate risk in the portfolio, without being so large that it limits the practical use of the rating system. To determine the appropriate number of grades beyond the minimum seven non-default grades, each

institution must perform its own internal analysis.

S. An institution must justify the number of obligor grades used in its rating system and the distribution of obligors across those grades.

The mere existence of an exposure concentration in a grade (or grades) does not, by itself, reflect weakness in a rating system. For example, banks may focus on a particular type of lending, such as asset-based lending, in which the borrowers may have similar default risk. Banks with such focused lending activities may use close to the minimum number of obligor grades, while banks with a broad range of lending activities should have more grades. However, banks with a high concentration of obligors in a particular grade are expected to perform a thorough analysis that supports such a concentration.

A significant concentration within an obligor grade may be suspected if the financial strength of the borrowers within that grade varies considerably. If obligors seem unduly concentrated, then management should ask themselves the following questions:

- Are the criteria for each grade clear?

Those rating criteria may be too vague to allow raters to make clear distinctions. Ambiguity may be an issue throughout the rating scale or it may be limited to the most commonly used ratings.

- How diverse are the obligors? That is how many market segments (for example, large commercial, middle market, private banking, small business, geography, etc.) are significantly represented in the bank's borrower population? If a bank's commercial loan portfolio is not concentrated in one market segment, its risk rating distribution is not likely to be concentrated.

- How broad are the bank's internal rating categories compared to those of other lenders? The bank may be able to learn enough from publicly available information to adjust its rating criteria.

Some banks use "modifiers" to provide more risk differentiation to a given rating system. A risk rating modified with a plus, minus or other indicator does not constitute a separate grade unless the bank has developed a distinct rating definition and criteria for the modified grade. In the absence of such distinctions, grades such as 5, 5+, and 5- are viewed as a single grade for regulatory capital purposes regardless of the existence of the modifiers.

Loss Severity Ratings

S. Banks must rank facilities by the expected severity of the loss upon default.

The second dimension of an IRB system is the loss severity rating, which is calibrated to LGD. A facility's LGD estimate is the loss the bank is likely to incur in the event that the obligor defaults, and is expressed as a percentage of exposure at the time of default. LGD estimates can be assigned either through the use of a loss severity rating system or they can be directly assigned to each facility.

LGD analysis is still in very early stages of development relative to default risk modeling. Academic research in this area is relatively sparse, data are not abundant, and industry practice is still widely varying and evolving. Given the lack of data and the lack of research into LGD modeling, some banks are likely, as a first step, to segment their portfolios by a handful of available characteristics and determine the appropriate LGDs for those segments. Over time, banks' LGD methodologies are expected to evolve. Long-standing banking experience and existing research on LGD, while preliminary, suggests that collateral values, seniority, industry, etc. are predictive of loss severity.

S. Banks must have empirical support for LGD rating systems regardless of whether they use an LGD grading system or directly assign LGD estimates.

Whether a bank chooses to assign LGD values directly or, alternatively, to rate facilities and then quantify the LGD for the rating grades, the key requirement is that it will need to identify facility characteristics that influence LGD. Each of the loss severity rating categories must be associated with an empirically supported LGD estimate. In much the same way an obligor-rating system ranks exposures by the probability of default, a facility rating system must rank facilities by the likely loss severity.

Regardless of the method used to assign LGDs (loss severity grades or direct LGD estimation), data used to support the methodology must be gathered systematically. For many banks, the quality and quantity of data available to support the LGD estimation process will have an influence on the method they choose.

Stress Condition LGDs

S. Loss severity ratings must reflect losses expected during periods with a relatively high number of defaults.

Like obligor ratings, which group obligors by expected default frequency, loss severity ratings assign facilities to groups that are expected to experience a common loss severity. However, the different treatment accorded to PD and LGD in the model used to calculate IRB capital requirements mandates an