
Minutes

**Minutes of the meeting of the
CREDIT RISK STANDING GROUP
Held on 15 July 2004 - 2pm
At FSA**

Present:

Ian Russell (Abbey)
Ed Duncan (ISDA)
Jonathan Gray (RBS)
Mike Pollitt (Nationwide)
John Phipps (BBA)
Phil Rogers (HSBC)
Colin Jennings (LTSB)
Alan Henderson (HBOS)
Steve Teather (Merrill Lynch)
Mike Mansfield (Morgan Stanley)
Tom Wilde (CSFB)
Alan Hilton (Barclays)
Riitta Jeffery (Standard Chartered)
Chris French (BSA)

Diane Hilleard
Hywel Dawes
Robert Hudson
Kevin Ryan
Claire Wallace

Apologies: Katherine Seal (LIBA)

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1 **Issues arising from policy visits on Loss Given Default in large corporate and mid market portfolios**

The purpose of the paper was to address the major issues which had

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come out of the policy visits on LGD.

The LGD questionnaire was intended to give firms clarity on what areas they should be focusing on for entry into Advanced IRB, but it was confirmed that this would not constitute part of the information required under phase one of the Application Pack.

CRSG members queried how the Application Pack would work in practice and it was stated that it would be a two stage process, with firms providing a broad range of information initially, and then FSA would focus on specific areas, usually including a visit.

It was commented that although the LGD approach in CP189 was broadly consistent with the new Accord, CP189 had been more prescriptive in defining the economic downturn scenarios as the LGD outcome in the worst year. This would often be statistically inaccurate.

FSA stated that work on LGD would be taken forward in the first instance by the Accord Implementation Group (AIG) and the Capital Task Force (CTF). The aim was to agree a consistent supervisory approach across Europe, with CEBS being the mechanism of change within the EU. However, it was noted that the product of the AIG/CTF would be unlikely to be included within the January CP.

The paper detailed 3 high level principles that could be drawn from the policy visits;

- the need to pursue accuracy at the level of individual facilities as opposed to broad portfolio averages;
- the need for estimates to take account of the experience and practices of the firm in question as opposed to just that of the industry as a whole; and
- the need for estimates, although based on empirical experience, to be aimed at providing estimates of losses in the future.

CRSG members commented that an approach to estimate LGD on a forward looking basis based on historical analysis of LGD drivers would be difficult to model, and also queried whether current and future economic trends for LGD estimation would need to be included. It was stated that it the aim was to predict what will happen in the future, based on past experience.

The members felt that there would a high variation in individual outcomes and that this would be hard to map across to tolerance bands.

Further requirements for LGD estimation included;

- the need to take account of the differences between a firm's own experiences and that of the industry as a whole, even in the cases where a model is built primarily on external data;
- the need for own estimates to include the impact of residual risk, at least as part of Pillar 1;
- the need, in accordance with the existing CRD proposals, to reverse out double default effects. The Trading Book review may result in changes to this requirement.

The CRSG members queried what would happen where firms had implemented a system based on current information, and then the requirements subsequently changed. FSA confirmed that it would need to take into account any Directive changes given its' legal constraints, but would seek to be flexible in giving firms time to make changes.

CRSG members opposed the production of a definitive list of LGD drivers. FSA stated that it would not expect firms to engage in 'cherry picking' and was presently in a position to identify only the most obvious drivers.

2 Further issues in Retail IRB

The purpose of this paper was to provide clarity on issues which FSA had previously not been able to do due to the instability of the Directive text.

Counting of days past due – the Capital Requirements Directive removed the ability to be flexible on this issue and an exact number of days past due is required.

FSA proposed to set either 180 days for all retail business other than SME, or 180 days for mortgages, 90 days for QRRE, SME mortgages and other retail.

It was stated that the 180 days would be a backstop for the definition as firms should have their own internal triggers, and this would only aim to capture genuine defaults.

The CRSG members were in favour of setting the number of days past due at 180 days as this would be the most practical solution and would not necessarily mean that a parallel system would have to be built. It was noticed that this may not necessarily be applicable to credit card

**BBA to
give
feedback
on CC
portfolios**

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portfolios, and BBA will provide industry feedback on this issue.

Issues with LGD

Application of 10% floor for mortgages - within the current draft of the Directive there is a transitional arrangement that the exposure weighted average LGD for mortgages should not be lower than 10%, but properties subject to central government guarantees would be exempt.

BBA to canvas members and feedback to FSA

CRSG members felt that on average the exemption for central government guarantees would not be relevant, with the possible exception of Hong Kong. BBA agreed to canvas its members and provide feedback to FSA.

Calculation of historical recoveries – no comments were made on this section

Material drivers of LGD & EAD – no comments were made on this section.

Retrospective rescoring – FSA cannot give further comment on this section until the European Commission have expressed their views on this.

Use of external scorecards & external data – FSA reiterated their view that for scorecards that had been built by external providers, the same requirements for internally built models would apply.

Although members were not adverse to this in principle, it was felt that for many portfolios this would be difficult – in particular for low default portfolios where bureau data would be hard to understand and difficult to decipher.

Products to be treated as qualifying revolving retail exposures – the latest Basel text states that firms have to demonstrate that the use of the QRRE risk weight function is constrained to portfolios that have exhibited low volatility of loss rates.

BBA to canvas members on the most appropriate way to meet this requirement.

Members were asked to consider how this requirement could be met. It was felt that this would be difficult to achieve in practice as the data requirements for entry to IRB are 5 years, and there has been little volatility in this time.

Members questioned what was meant by 'sub portfolio' and whether this would apply to individual loans or across a pool.

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Independent validation – it was stated that review of the firm's rating systems by Internal Audit is an important safeguard to the integrity of the systems, although it is recognised that the skills required to conduct such a review effectively may not be present within the audit team.

CRSG members commented that another area of the group should perform the validation effectively sub-contracting the work but without sub-contracting accountability. One member felt it was necessary to propose to the Commission that the Directive was changed back to the original Basel language.

FSA to consider this issue

Buy-to-let mortgages – no comment was made on this section.

Islamic mortgages – no comment was made on this section.

Minimum EAD – no comment was made on this section.

Stress testing – no further discussion was held on this section as it was covered in an FSA FAQ.

Restructuring as a default event – no comment was made on this section.

Use of property price indices to update LTV – it was stated that FSA would not state what particular indices would be appropriate, this would be part of the firm visit programme.

Members were asked to consider what factors could be relevant in determining the acceptability of indices and revert to FSA with suggestions.

Metrics for data accuracy – no comment was made on this section.

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AOB

CRSG members queried whether it was possible, due to the frequency of meetings to provide formal responses to FSA papers after the meetings had taken place. FSA stated that this was possible, and where appropriate, feedback would be given at subsequent meetings.

BBA to provide FSA with any additional comments