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To: U.S. Banking Regulatory Agencies

From: RMA Capital Working Group¹

Re: Capital Treatment of Credit Cards and Securitized Card Receivables

This memorandum is intended to provide a framework for implementing a flexible, risk-based treatment of regulatory capital for credit cards. The general logic behind the measurement of Economic Capital for card receivables and associated undrawn lines has been discussed in previous RMA papers, including our most recent paper on the subject early this month.² We therefore concentrate here only on a specific method for implementation of a regulatory capital framework that reflects, in broad terms, best internal practices. We are suggesting this framework now because we understand there to be a diversity of views on the subject across the U.S. banking agencies and within the rest of the Basel community. This divergence of views, moreover, extends not only to the capital treatment of on-balance-sheet bank interests in unsecuritized card receivables but also to the appropriate treatment of securitized accounts, including drawn balances and unused lines of credit.

Our suggested framework would have the following elements.

1. Asset-Value-Correlations (“AVCs”). The most important element of any risk-based Basel II capital treatment is to “get right” the relative capital risk-weights, which, in the context of the AIRB ASRF model, means setting appropriate AVCs. This most important first step could be accomplished in either of two broad ways:

- a. Permit AIRB banks, with appropriate supervisory oversight, to use internally estimated AVCs for credit card exposures. As we have indicated elsewhere, such an approach could represent an important first step toward moving the AIRB approach in the direction of a full internal models approach. The resulting dialogue between supervisors and bank EC analysts would help clarify the range of acceptable practice for estimating such parameters and simplify the process of migrating toward internal estimation of AVCs for other credit products. To be clear, current industry practice would support AVCs that are significantly less than the current proposal of 2% to 11%.
- b. Replace CP3’s AVC function (which has AVCs for revolving retail credits decreasing as PD rises) with a flat AVC of 2-3% across the range of PDs. Our

¹ The Capital Working Group of RMA — The Risk Management Association -- consists of senior risk management officers at large banking organizations responsible for the measurement of risk and the determination of Economic Capital. The names of the institutions represented on the Capital Working Group, along with staff members contributing to the preparation of this memorandum, are shown in an Appendix. Individual banking organizations that are members of the Group may be responding separately to the questions raised by the U.S. agencies and may hold opinions regarding Basel II and the U.S. ANPR that differ from those expressed in this memorandum.

² See “Industry Practices in Estimating EAD and LGD for Revolving Consumer Credits -- Cards and Home Equity Lines of Credit”, RMA Capital Working Group, March 2004.

earlier papers have discussed the logic behind the level and slope of the AVC function. Please note that, so long as Basel sets these AVCs at even modest levels above the 2-3% range, there would be a significant divergence from internal EC practices, as well as a greater likelihood that the Basel AIRB approach, rather than producing a true minimum capital charge, would be binding for individual institutions.

2. Treatment of drawn balances in securitization transactions for cards. As we have indicated, there is a diversity of practice in the industry associated with the amount of credit risk that is retained by sponsors in a pool of securitized card accounts. There is a strong consensus, however, that there is positive risk transference (reducing accordingly the bank's internally estimated EC). In this regard, there is also a strong consensus that the structure of the Credit Conversion Factor ("CCF") in CP3 should be retained, even if there are changes in the parametric values used within the CCF. We take this view because there are two primary determinants of the amount of transferred credit risk – a) the current level of excess spread generated by the pool of underlying accounts, and b) the specific nature of the legal "waterfall" inherent in the securitization structure. The *level* of credit risk (in terms of loss-at-the-confidence interval over the one year horizon) is determined importantly by the current level of spreads – the higher the spreads, the lower the probability that a decline in pool performance would result in any particular actual loss. Likewise, the portion of that credit risk retained by sponsors is determined both by the level of current excess spread and by details of the legal structure for the particular securitization. Of these two determinants – current excess spread levels and waterfall structure -- only the existing level of excess spread is easily measured and can be applied directly to all securitizations, regardless of transaction structure detail. Thus, the RMA Group believes that it is critical to retain CP3's CCF approach, in which the CCF applied to investors' interest in drawn balances is a function of the difference between current spread and the spread at which early amortization is triggered.

Under this framework, as specified in CP3, there is some high spread level at which the CCF is zero, while at very low spreads, (spreads approaching the early amortization trigger) the CCF is 100%. However, at least in principle, there may be some positive credit risk to the sponsoring bank (associated with investors' balances) even when the current amount of excess spread is very high. Conversely, as spreads reach the early amortization trigger point, it may still be appropriate to attribute some transference of credit risk to investors' balances, due to the credit enhancing features of the securitization, such as the existence of insurance or subordinated tranches held by third parties. Thus, when spreads are very low, even when the transaction is in early amortization, the CCF should, at least in principle, never reach 100%.

With respect to *internal* economic capital treatment of investors' interests, there is a wide diversity of practice among our members – some treat the effective CCF as if it were always 100%, while some treat the CCF as if it were always close to zero. Many of our Group's members are working diligently on quantitative measurements of the degree of credit risk (EC) that is retained by sponsors in the context of securitization transactions. Thus, over time, new research may shed light on possible improvements to a Basel II CCF function.

3. Treatment of the undrawn portion of the line (for banks and investors). CP3 requires the AIRB bank to estimate a loan-equivalency ("LEQ") for the undrawn portion

of the card account's line. Under CP3, 100% of the UL capital attributable to this LEQ is allocated to the sponsoring bank in the case of securitized as well as unsecuritized accounts. We agree with the principle that LEQs should be determined by the bank, with appropriate supervisory oversight, because each bank has a unique process for managing its exposure to undrawn lines. In banks with stronger management procedures for reducing such exposures (by, for example, closing out the unused line when behavior of the obligor warrants), the LEQ will be consequently a smaller portion of the unused line. However, we disagree in principle with the notion that 100% of such estimated LEQ should be attributable to the bank in the case of securitized accounts. As discussed in previous papers, as long as paybacks are equal to or greater than draw-downs of unused lines (on a pool basis) the investor shares with the bank in absorbing the credit risk associated with such draw-downs. If draw-downs of unused lines are greater than principal paybacks, however, the bank must fund correspondingly more of line draw-downs. Thus, it would be most appropriate for Basel II to establish some "sharing" of the LEQ associated with unused lines (between the bank and the investors), based on, say, the level of excess spread. In the absence of evidence to the contrary, we believe it is appropriate for Basel to use the same CCF (as a function of excess spread levels) it applies to drawn balances to also apportion capital for the "investors' interest" in the LEQs associated with undrawn lines.

4. Calculating the AIRB UL capital charge. Once Basel decides on a rational treatment of AVCs and on appropriate CCFs for the investors' balances and the investors' share of the LEQ associated with undrawn lines, there would need to be some changes to the CP3 method of calculating AIRB capital, simply for the sake of consistency. Under CP3, there is a dollar for dollar deduction from Tier 1 capital levied against that portion of the I/O strip associated with the gain on sale (for securitized accounts). Further, the amount of the I/O strip beyond the gain on sale is deducted from Total Capital (50% from Tier 1 and 50% from Tier 2). We agree with a deduction of the gain on sale, net of tax, from Tier 1 capital, since a) the amount of the gain actually realized is contingent on the performance of the securitized loans, and b) deduction of the gain on sale, net of tax, places the regulatory capital treatment of securitized accounts on the same footing as the treatment of unsecuritized accounts. However, in the context of the approach we have outlined above, all other bank assets associated with the securitization of card accounts should attract a regulatory capital charge that is strictly determined by application of the Basel ASRF model. Thus, there would be no further deduction of the I/O strip above the gain on sale -- and the remaining amount of the I/O strip, plus all other positions of the bank (including retained positions that are securities issued by the trust) associated with securitized accounts should attract regulatory capital calculated by application of the ASRF model to the components of exposure related to the securitized accounts. That is, rather than measure regulatory capital as some percentage of bank assets related to the securitization, Basel would measure regulatory capital as a percentage of the loan-equivalent amounts associated with the underlying accounts. The Basel ASRF model would be applied to a) the outstanding drawn balances of securitized accounts attributable to the seller's interest; b) the outstanding drawn balances stemming from application of the CCF to the investors' interest in drawn balances; c) the LEQ associated with undrawn balances attributed to the bank; and d) the LEQ associated with the investors' interest (via application of the CCF to the estimated

LEQ for undrawn lines attributed to investors).³ Note that by using this procedure, the regulatory capital charge for securitized accounts *cannot* be as high as K_{IRB} , so long as some CCF less than 100% is applied to investors' balances and investors' interest in the LEQs of undrawn lines.

Note further that, no matter how low Basel sets the CCF, there is still the potential for a misalignment of incentives when comparing the Standardized approach for credit cards with the AIRB approach for cards. This is because the Standardized approach calls for a 6% total capital charge against the bank's interest in drawn balances – without assigning *any* capital to the LEQs of undrawn balances or to the investors' interest in drawn balances. The proper way to fix this problem is to change the Standardized approach, not tinker with the AIRB approach in a manner that does not reflect best practices.

5. The implicit recognition of future margin income (“FMI”). As we have indicated in our papers, margins represent a real cushion against future credit losses, more so than covering simply the EL portion of the loss on the ASRF loss distribution at any given confidence interval. Basel has implicitly recognized the importance of FMI by calculating regulatory required capital (after the Madrid conference) as Loss-at-the-Confidence-Interval minus EL. However, this action was offset to a significant extent by permitting the Allowance for Loan and Lease Losses (“ALLL”) to count as Tier 2 capital only to the extent that the ALLL exceeds EL. “Shortfalls” of [ALLL – EL] are to be deducted 50% from Tier 1 and 50% from Tier 2 capital. Unfortunately, in the U.S., the ALLL is established according to GAAP, which may or may not align with the economic concept of EL. In particular, U.S. banks are not permitted to establish a loan loss reserve for undrawn lines or the investors' interest in drawn balances. Moreover, some banks do not reserve for accounts held for securitization (which are carried at fair value or LOCOM). As a consequence, [ALLL – EL] is in a shortfall for banks securitizing card accounts and therefore results in a further deduction from capital. This problem is especially acute for mono-line card banks for which there are no other business lines generating an excess of ALLL over EL. Of course, the RMA Group has long argued that the ALLL represents a real cushion against credit losses and should, without limit, be counted as Tier 1 capital.

In order to appropriately address these issues, application of the Basel AIRB model according to the structure we have outlined above should be accompanied by not subtracting from Tier 2 ALLL the following: a) the EL associated with investors' interest in drawn balances, b) the EL associated with LEQs of undrawn lines, and c) the EL associated with accounts held for securitization.

Finally, we would like to point out that the logic of the discussion above, in all its parts, should apply not only to credit cards but also to *any* credits that involve revolving lines and the securitization of such accounts. Thus, home equity lines of credit (“HELOCs”) should be afforded similar AIRB treatment as outlined above for securitization of credit card accounts.

³ To be clear, we are recommending two things: First, that the investors' “interest” in undrawn lines be treated as existing in the same proportion (to the seller's interest in undrawn lines) as the investors' interest in drawn balances relates to the seller's interest in drawn balances; second, that the same CCF used for investors' interest in drawn balances also be used for converting the investors' “interest” in the LEQs of undrawn lines into an exposure attributable to the bank.

We appreciate this opportunity to engage in further constructive dialogue with the banking regulators, and we hope that the framework we have outlined in this memorandum will prove useful in helping the agencies achieve a consensus on this important matter. As always, we stand ready to share our thinking on best practices in this arena.

Appendix

Institutions in the RMA Capital Working Group:

Bank of America	Bank of Montreal
Bank of New York	Bank One
Capital One	Citicorp
Comerica	Discover Financial Services
FleetBoston Financial	Household International (HSBC)
JPMorganChase & Co.	KeyCorp
MBNA	PNC Financial Services Group
Providian Financial	Royal Bank of Canada
Union Bank of California	Wachovia
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