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Re: Proposed Supervisory Guidance on Internal Ratings-Based Systems for Retail Credit Risk for Regulatory Capital (Office of the Comptroller of the Currency Docket No. 04-22; Office of Thrift Supervision No. 2004-48; Federal Reserve Board Docket No. OP-1215); 69 Fed. Reg. 62,748 (October 27, 2004)

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Ladies and Gentlemen:

HSBC North America Holdings Inc. ("HSBC North America") appreciates the opportunity to comment on the proposed supervisory guidance on Internal Ratings-Based Systems for Retail Credit Risk for Regulatory Capital (the "Guidance") issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (collectively, the "Agencies"). The Guidance will create nationwide supervisory standards for an IRB credit risk system to determine the regulatory capital treatment for retail credit exposures

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under the new Internal Convergence of Capital Measurement and Capital Standards, which was adopted by the Basel Committee on Banking Supervision in June 2004 ("Basel II Framework").

HSBC North America is a wholly-owned subsidiary of HSBC Holdings plc ("HSBC Holdings"), and is the bank holding company through which HSBC Holdings conducts its operations in the United States and Canada. HSBC Holdings is the largest banking organization headquartered in the United Kingdom and is the second largest banking organization in the world by market capitalization.

As a leader in retail lending with approximately $200 billion in managed retail credit assets, HSBC North America and its subsidiaries would be directly affected by the standards proposed by the Guidance. HSBC North America is a bank holding company that operates various bank and non-bank subsidiaries. Its largest bank subsidiary, HSBC Bank USA, N.A., Wilmington, Delaware, has more than 400 branches in the states of New York, Florida, Pennsylvania, California, Washington, Oregon, and the District of Columbia. HSBC North America also owns HSBC Finance Corporation (formerly, Household International, Inc.), one of the largest credit card issuers and consumer lenders in the United States with over 50 million customers. Other subsidiaries of HSBC North America, including HSBC Securities (USA) Inc., an investment bank registered with the Securities and Exchange Commission, engage in a broad range of financial activities in the United States and Canada.

The following comments provide HSBC North America's view on certain standards set forth in the Guidance the we suggest should be revised, deleted, or clarified. The letter also provides general comments on the Guidance as a whole and, more specifically, which supervisory standards should reasonably be required as mandatory minimum qualifying criteria for use of the retail IRB approaches.

1. Policies and Board Involvement:

As an overall matter, we are concerned that in certain sections the Guidance refers to the creation of a "policy" where what actually may be intended or justified is a documented process or guideline. In these cases we suggest that the terminology be changed to avoid unnecessary documentation and to allow organizations the flexibility to implement new processes as information and circumstances require. The table below indicates where we believe such terminology changes are warranted.

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Table 1: Summary of policies required in the IRB Retail Guidance

| Section | Proposed Requirement | HSBC Recommendation |
|---|---|---|
| Par. 45 | Policy for monitoring and updating information on exposure risk characteristics and on migrating exposures between segments | Replace "policy" with "documented process." |
| Par. 67 | Policy for reconciling different estimates between risk parameters | Replace "policy" with "documented process." |
| Par. 77 | Policy for reviewing and updating the segmentation and quantification design. | Require periodic review and updating of segmentation and quantification design. |
| Par. 78 | Policy for process and frequency of updating the risk parameter estimates. | Require periodic review and updating of risk parameter estimates. |
| RS-16 | Banks that combine estimates from internal and external data or that use multiple estimation methods must have a clear policy governing the combination process and should examine the sensitivity of the results to alternative combinations. | Replace "clear policy" with "clearly documented method." |
| RS-17 | A bank must have a clear, well-documented policy for addressing the absence of significant data elements in either the reference dataset or the existing portfolio. | Replace "policy" with "process." |
| RS-34 | Banks must develop statistical tests to back-test their IRB risk quantification processes. Banks must establish tolerance limits for differences between expected and actual outcomes, and banks must have a validation policy that requires and outlines remedial actions to be taken when policy tolerances are exceeded. | We agree that this requirement should be documented in a formal policy. |
| Par. 189 | The bank's validation policy should describe (at least in broad terms) the types of required responses when relevant action thresholds are crossed. | We agree that this is appropriate content for the validation policy. |
| Par. 223 | Policy to document responsibilities and lines of authority regarding accountability with respect to control and oversight mechanisms. | We agree this should be documented in policy. |

There are also several sections of the Guidance, as well as previous related publications (see, e.g. "Risk Based Capital Guidelines; Implementation of New Basel Capital Accord," 68 Fed. Reg. 45,900 (August 4, 2003)) that establish responsibilities of each institution's board of directors. We suggest that these may merit additional clarification to highlight where they augment or differ from each board's existing responsibility to oversee bank operations and business performance, keep informed about the bank's operating environment, hire and retain competent management, and ensure that the bank has a risk management structure and process suitable for the bank's size and activities. In the future, it may be helpful for the industry if the Agencies consolidated their expectations of board involvement with IRB implementation in a single document or section of a

document. As currently written, these are spread throughout IRB publications, and in some cases, could be interpreted to impose new reporting requirements on board members. For example, paragraph 225 states that "[f]or retail portfolios that are managed across legal entities, the board of directors and senior management of each insured depository institution must have sufficient information about its exposures to accurately assess and report on its own risk." 69 Fed. Reg. 62,748, at 62,771 (October 27, 2004). This statement could be revised to state: "[f]or retail portfolios that are managed across legal entities, information and management reports must be available on a legal entity basis which is sufficient to enable the board of directors and senior management of each insured depository institution to accurately assess the risk affecting their particular institution and to ensure that risk is accurately reported."

2. Risk Segmentation Criteria/RS-4 and Use of Risk Estimates/RS-55:

RS-4 requires that banks "clearly define and document the criteria for assigning an exposure to a particular retail risk segment. The risk factors used for IRB risk segmentation purposes must be consistent with internal methods of assessing credit risk for retail exposures." 69 Fed. Reg. at 62,755. The Guidance then provides some alternative techniques for determining appropriate segmentation. Later in the document, RS-55 contains a parallel requirement that:

> Retail IRB risk parameter estimates must be consistent with risk estimates used to guide day-to-day retail risk management activities.
>
> 239. Banks must demonstrate that IRB segmentation and IRB risk parameter estimates are consistent with those used by bank management in its planning, execution, and oversight of retail lending activities. Risk drivers for IRB segmentation purposes should correspond to risk drivers used as part of the overall risk management of the lines of business. IRB risk parameter estimates of PD, LGD, and EAD should be incorporated in credit risk management, internal capital allocation, and corporate governance. Banks should compare actual default rates with PD and actual dollar loss rates with internal forecasts for each of the retail IRB products.

69 Fed. Reg. 62,770. Our concern with RS-4 and RS-55 as stated is that they could be interpreted by examination staff to require institutions to limit their risk management tools to PD, LGD, and EAD, to the exclusion of other measures. Such a literal interpretation could stifle development of more advanced risk management measurements which the Guidance encourages institutions to develop. In particular, we are concerned that the use of parallel risk factors for IRB segmentation purposes and internal credit risk measurement fails to recognize the variety of ways that retail credit risk is viewed for many operational

purposes. In this respect, we note that segmentation used to view portfolios for IRB purposes is simply one of a variety of useful ways to look at a business. There may be other appropriate ways to look at a business that are more appropriate for other risk management purposes, and these risk management techniques should not be limited by the Guidance (nor should an institution's IRB segmentation be limited by its existing risk criteria). Finally, we note that both RS-4 and RS-55 appear to be more appropriately considered as "best practices" than requirements for IRB qualification (see section 10, below).

As a large retail lender, HSBC North America uses a variety of models to manage its portfolios and products on a daily basis. These models may be used to manage risk related to underwriting standards, product features, pricing, and funding costs, among other items. They may also be used to determine reserve requirements, allowances, and efficient capital utilization. They may be created to assess the performance or profitability of a specific purchased portfolio or a particular vintage of loans, or to compare performance of loans differentiated by channel (e.g., to compare internet-originated loans to branch-originated, and to compare new loans to refinanced loans). Models may be created to compare performance of borrowers in different states, or with different leverage ratios, or those who were underwritten using different credit scoring systems. While certain factors used to create various internal models may correspond to those used in IRB segmentation models, we believe that it would be inappropriate to require that the IRB factors drive the development of internal models, or vice versa.

To address our concerns with RS-4 and RS-55, we suggest first that neither be considered mandatory for IRB qualification. Next, if the language of each is retained in the final document as a requirement or guideline, we would suggest the following: either (1) deleting the second sentence of RS-4 in its entirety (i.e., "[t]he risk factors used for IRB risk segmentation purposes must be consistent with internal methods of assessing credit risk for retail exposures"), deleting RS-55 in its entirety, and delete the first two sentences of paragraph 239 in their entirety; or (2) replacing the word "must" with "may" in RS-4, RS-55, and the first two sentences of paragraph 239.

3. Retail Quantification Process/RS-11:

Paragraph 78 requires that "[a]t a minimum, the risk parameter estimates must be updated at least quarterly and more frequently if deemed necessary for accurate credit risk management." We would suggest that this language be clarified to require a review of risk parameter estimates on at least a quarterly basis, and to require updating of those estimates only if judged necessary by the review for accurate risk management. Specifically, we suggest this language be replaced with the following: "[a]t a minimum, institutions must review risk

parameter estimates on a quarterly basis, or more frequently if required to accurately assess risk. Risk parameters should be updated as deemed necessary by the results of these reviews."

4. Definition of Default/RS-18:

The Guidance provides a definition of "default" that qualifying banks must use for estimating IRB Retail risk parameters. The purpose of defining "default" for IRB purposes is to estimate credit-related economic losses, referred to as "loss given default," or "LGD". The data set to be used in estimating LGD includes " the circumstances of default, for example, roll to charge-off or bankruptcy leading to charge-off, if they are significant." 69 Fed. Reg. 62,761. The Guidance states specifically that a retail exposure will be considered in "default" for IRB purposes when any one of three listed events occurs – a "loss" occurs, as defined by the Federal Financial Institutions Examination Council ("FFIEC") Uniform Retail Credit Classification and Account Management Policy; the exposure is either partially or fully charged-off; or, the exposure is put on non-accrual status.

We do not believe the last event, that the exposure is put on non-accrual, is appropriately contained in the definition of "default" for IRB purposes and we recommend that it be deleted from this section. Specifically, we are concerned that using the term non-accrual to define default risks fundamentally accelerating the definition of default. The effect of such acceleration could be to moot existing definitions of default currently used by the industry. Further, the definition of non-accrual contains subjective elements which are judgmental in nature and therefore does not lend itself well to consistency of implementation either within or across institutions. This would result in a number of implementation and programming challenges for retail lenders as well as supervisory challenges for regulators.

5. Use of Seasoning Data/RS-19:

The Guidance requires that estimates of probability of default ("PD") "must be empirically based and must represent the average over time of segment default frequencies on an account basis. The effect of seasoning, prepayments, and attrition must be considered in the PD estimates." 69 Fed. Reg. at 62,760. In other words, the Guidance requires banks to factor the impact of seasoning and prepayment into their assessment of capital adequacy. While we agree that measuring and monitoring the effects of prepayment and seasoning of loans in a particular portfolio are appropriate risk management functions at a retail lending institution, we suggest that their inclusion in the estimations of PD is inappropriate.

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As seasoning and prepayments primarily impact revenue items on a bank's balance sheet, reports on these factors would be more appropriately required in the day-to-day risk management monitoring and reporting at an institution. Moreover, the requirement is inconsistent with the IRB requirement that a bank's segmentation be based on actual portfolio results. These results would include the performance of loans for the period they are on the bank's books. As a result, we recommend that this requirement be removed (e.g., delete "[t]he effect of seasoning, prepayments, and attrition must be considered in the PD estimates") from RS-19, as well as related comments in paragraphs 109-112.

6. 10% Floor for LGD Related to Residential Mortgages/RS-23:

In contrast with the methodologies for estimating Loss Given Default ("LGD") for other types of loans, for an initial two-year implementation period, the Guidance sets a minimum floor of 10% for the LGD in a residential mortgage portfolio. The Guidance indicates that the agencies take the view that the LGD for residential mortgages is unlikely to fall below this level, but does not indicate on what information they base this opinion. There is also no indication that there is any flexibility to this floor (at least during the two-year implementation period) with respect to an institution whose data would indicate a lower percentage is appropriate for these home-secured loans. At a minimum, we would suggest that the agencies provide some indication of the basis for the 10% floor so that affected banks can better understand the regulatory approach and considerations. Further, we suggest that a more appropriate approach might be to eliminate the floor during the implementation period, allowing for a review of actual institution data during the parallel run year, during which time substantial historical data will be available to analyze actual mortgage performance.

7. Data Retention Requirements/RS-36:

The Guidance requires banks to retain "all significant data elements used in the IRB retail credit risk system for at least five years and must include a period of portfolio stress. This data retention requirement applies to all loans and lines that were open at any time during this period." 69 Fed. Reg. 62,769. While we agree with the utility of including a period of portfolio stress (if that five years does not include one), the requirement as written appears impractical in its subjectivity and could present institutions with unwarranted programming complexity. We suggest two potential alternatives. One possibility would be to modify paragraphs 203-208 to further define what the Agencies consider "a period of economic stress," which would add more certainty to industry compliance with the standard. Or, require the data to be maintained for a longer, specific length of time. For example, a ten-year period would provide considerable portfolio data for the "robust historical database" contemplated by the Guidance, while allowing data to be destroyed at a specific point in time. Moreover, while the Guidance

indicates that retention is favored for "as long a period as possible" (paragraph 207), we submit that changes in the retail lending business and external economic conditions will often render data older than ten years as stale and of limited analytic utility.

8. Quantification of Exposure at Default ("EAD")/RS-25:

The Guidance requires banks to quantify EAD for each portfolio segment. 69 Fed. Reg. at 62,762. To quantify EAD with respect to purchased portfolios, the Guidance provides that:

> Par. 153: Purchased retail receivables are treated the same as other categories of retail exposures, except for the effects of dilution. Dilution effects refer to the potential reduction in receivable balances caused by cash or non-cash credits granted to the receivables' obligor(s). Examples include offsets for the return of goods sold and discounts given for prompt payment. If dilution poses a material risk, banks should estimate an expected (long-run average) one-year dilution rate (as a percentage of the receivables amount.) The minimum regulatory capital requirement for dilution risk is determined according to the *corporate* risk weight formula.
>
> Par. 154: When refundable purchase price discounts, collateral, or partial guarantees provide first dollar loss protection for purchased retail receivables, banks may treat these as first dollar loss protection under the IRB securitization framework and use that framework for the calculation of minimum capital requirements for the purchased retail receivables. Alternatively, the bank may choose to treat EAD as the purchase price.

Id. From a policy standpoint, we note that any capital treatment related to purchased portfolios will affect the liquidity of the market for distressed portfolios. By requiring higher capital levels for purchased loan portfolios, the Guidance risks negatively impacting the marketability of these loans by requiring purchasers to hold extra capital than our experience suggests is warranted. Specifically, by requiring that the expected loss ("EL") and the unexpected loss ("UL") be reduced at the same rate as the purchase discount (as indicated in Appendix B, Example 8, 69 Fed. Reg. 62,776), our experience indicates that the Guidance overstates the true loss exposure on a discounted acquisition. Moreover, we suggest that chargeoffs, to the extent they do not exceed the purchase discount, carry no extra loss exposure to the acquiror, and therefore should not be considered in calculating the acquiror's required capital levels.

Rather than set forth a methodology that unnecessarily penalizes a purchaser who may have the operational expertise to successfully manage a discounted portfolio, we recommend that the purchase discount for these loans be treated similarly to the treatment of loss provisions (i.e., dollar for dollar coverage of expected loss). We believe such treatment will more accurately establish capital

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levels for acquirors of distressed portfolios, and will not produce an unwarranted hurdle for troubled institutions seeking to sell problem loans.

9. Control and Oversight Mechanisms:

Throughout the Guidance there are numerous references to, and requirements for, validation and control functions, independent review processes, and increased risk management oversight. We strongly agree with the need for robust risk management processes and controls over retail lending activities to ensure credit quality, data integrity, transparency, and accountability. We also firmly believe that institutions can successfully structure controls in a variety of different ways that will ensure the integrity of the risk segmentation systems and the accuracy of the risk parameter estimates used for determining regulatory capital under the IRB framework. Paragraphs 222 and 223 of the Guidance appear consistent with this belief. In particular, they provide that "[b]anks will have flexibility in how these elements are combined, provided they incorporate sufficient checks and balances to ensure that the credit risk management system is functioning properly;" and "[t]hese controls can be combined or structured to reinforce one another in a variety of different ways." What concerns us, however, is that the Retail Standards that follow these opening paragraphs (RS-46 through RS-58) appear very prescriptive and risk being rigidly enforced in practice. Thus, a literal interpretation of these subsequent paragraphs risks causing unwarranted regulatory burden at institutions where a supervisor could deem numerous layers of independent review and oversight functions to be absolute requirements. Thus, it would be helpful for the final document to clarify the Agencies' overall expectation with respect to the layers of validation, quality control, independent review, and internal and external audit functions. In addition, we would suggest that the final document contain added emphasis on allowing institutions flexibility in developing these processes, so long as the spirit and intent of the Guidance is followed. Finally, we would suggest that several of these standards would be more appropriate as guidelines, rather than requirements for IRB qualifications (RS-47 through 51, RS-55, and RS-58).

10. Mandatory Requirements:

The Agencies specifically request comment on whether any of the standards set forth in the Guidance should be mandatory minimum qualifying criteria for use of the retail IRB approaches, or criteria for supervisory guidance purposes only. Listed below are supervisory standards which appear to be reasonable requirements for IRB qualification. Other standards in the guidance appear more appropriately categorized as supervisory guidelines.

- Segmenting exposures into pools with homogeneous risk characteristics.

- Segmenting defaulted assets on the basis of risk characteristics predictive of loss and recovery rates.
- Supporting the use of guarantees and risk mitigants.
- Validating that the segmentation process separates exposures into segments with homogeneous risk characteristics that generate reliable long-run estimates of the IRB risk parameters.
- Including the review of developmental evidence, ongoing monitoring and back testing in the validation process.
- Basing the quantification on the best available data
- Using the IRM definition of default (but see comments above, section 3. "Definition of Default."
- Reflecting the concept of "economic loss" in the estimates of LGD.
- Providing an estimate of EAD for each segment.
- Maintaining a validation process that covers all aspects of IRB retail quantification.
- Conducting ongoing verification on the developed risk segmentation system and quantification process to ensure proper implementation.
- Collecting and maintaining sufficient data to support the IRB retail credit risk system.
- Retaining sufficient data to support IRB validation requirements.
- Reconciling aggregate exposures across all risk segments.
- Implementing an effective system of controls and oversight.
- Maintaining a comprehensive, independent review process that is responsible for ensuring the integrity of the IRB risk segmentation system and quantification process.
- Annual evaluation of compliance with the retail IRB capital regulations and supervisory guidance by internal and external audit.
- Board review and approval of key elements of the IRB system.

* * *

We appreciate this opportunity to submit comments on the Guidance, and support the Agencies' efforts to create nationwide standards on these issues. If you should have any questions or comments regarding this letter, please feel free to call me at the number listed below or Martha Pampel, Associate General Counsel, at (847) 564-7941.

Sincerely,

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