



KeyCorp's Response to "The New Basel Capital Accord" (Consultative Paper) dated January, 2001

INTRODUCTION

KeyCorp considers itself privileged to be able to comment on the Basel Committee's Consultative Paper (January, 2001) on Capital Adequacy Framework, which clearly creates a milestone in regulatory oversight for financial institutions all over the world.

KeyCorp has actively participated with industry groups such as IIF and RMA in constructing their responses to the June, 1999 Consultative paper and the January, 2001 Consultative paper. We are truly honored to have had the opportunity to work with them, as well as all other participating financial institutions.

We are in general agreement with the overall positions taken in the RMA industry group's response to the January, 2001 Consultative paper. Listed below are our specific comments (both Pillar 1 and Pillar 2) that we would like to highlight:

CORPORATE CREDIT

- The curve implied by the Foundation IRB capital formula is much steeper than the step function in the Standardized method. For example, for non-investment grade credits (PD's > 0.7%) much more capital is required under the Foundation IRB method as credit quality decreases. **This creates a disincentive for an organization with most of its portfolio in non-investment grade (or unrated) to move from the Standardized method to the Foundation IRB method.**
- **We believe that the 50% LGD assumption for all senior debt (except for Real Estate and Cash Equivalent) is too high in the Foundation IRB method.** While 50% LGD may be appropriate for unsecured loans, secured loans should have a lower LGD.
- In the Foundation IRB method, most collateral types offer no risk mitigation. **We believe that inventory, accounts receivable, and FF&E do offer some protection, and loans with these collateral types are more favorable when compared with unsecured loans.** Perhaps another category (e.g., a 45% LGD) could be used for these types of collateral.

- **In the Foundation IRB method, the maximum benefit for Commercial Real Estate collateral is a 40% LGD, which we believe is too conservative.** (This benefit occurs only if the loan to value ratio is less than 70%.) Most data sources show long-term LGDs for Real Estate secured loans to be significantly lower than 40%.
- **We believe that the off-balance sheet exposure at default (EAD) of 75% in the Foundation IRB method is too high.** This figure is also not consistent with the Standardized method. This leads to a **higher capital in the Foundation IRB method than in the Standardized method.**
- **We believe that a maturity component should be included** as part of the account segmentation in the Foundation IRB method.

RETAIL CREDIT

- Although illustrative in nature, the IRB Advanced method for Retail clearly **highlights the importance of risk-ranking the Retail portfolio**, and moving away from the “one-size-fits-all” regulatory capital requirements currently in place for all non-mortgage Retail products. We understand Retail is a work-in-process, and are excited to play a role in the ultimate crafting of regulatory capital requirements for this portfolio.
- The current Accord draft states that “the illustrative risk weights for retail portfolios may **overstate appropriate minimum capital levels for higher-PD retail products**”. In applying these risk weights to our own portfolio, we agree with that statement. **But, we also believe that capital is understated in the very low PD ranges.** This is due to the nature of the illustrative model, which is driven by a constant asset value correlation. Consequently, we feel that a decreasing asset value correlation (or a constant “default correlation”) is more fitting for Retail. This would result in a flatter curve, which would allow for both higher risk weights at the low-PD end, and lower risk weights at the high-PD end, when compared to the current illustrative risk weights. Therefore, due to the concave nature of the curve, capital increases much less than proportionate to EL at high levels of EL. **We are currently working with RMA to provide our internal model as a possible alternative to the illustrative model.**
- As is stated in the current Accord draft, a standardized approach for Retail will be developed “depending on the work currently being undertaken in the field of the IRB”. On the surface, it appeared that a Standardized approach should be developed first, but in fact constructing it last makes a lot of sense. By working backward (i.e., constructing the IRB Advanced method first and the Standardized method last), **it will be easier to build in the right incentives for banks to strive for the ability to move to the Advanced IRB method.**
- **Although the Standardized approach will be constructed at a later date, we still have a perspective on a general format.** We envision a Standardized approach that takes into account the following:
 1. diversification effects (i.e., lower risk weights versus Commercial),
 2. different levels of loss depending on LGD (in effect, segmenting by product type),
 3. a well-recognized industry tool (e.g., Fair, Isaac’s generic credit bureau score) to gauge credit risk for consumer portfolios.

Illustration only:	Fair, Isaac's Generic Credit Bureau score range:						
	<u>800+</u>	<u>750-799</u>	<u>700-749</u>	<u>650-699</u>	<u>600-649</u>	<u>below 600</u>	<u>no score</u>
Mortgages/secured by real estate	10%	20%	35%	50%	75%	100%	75%
Other secured lending	20%	35%	50%	75%	100%	125%	100%
Unsecured lending	35%	50%	75%	100%	125%	150%	125%

In principle, this illustration is similar to the Standardized method for Corporates already included in the Consultative paper.

- The current proposal calls for Advanced IRB banks to segment their portfolios on the basis of four main techniques – by product type, borrower risk/credit score, delinquency status, and vintage. It is stated that segmentation by product type and borrower risk/credit score is mandatory and that supervisors may determine that the others (delinquency status and vintage) are not appropriate for select institutions (e.g., due to the size of operations). **We agree with the importance placed upon segmenting the retail portfolio appropriately. However, we think more flexibility should be given to the banks to determine how to segment each of their individual portfolios.** Today, banks segment their portfolios on a regular basis to understand risk/reward tradeoffs, build pricing models, and forecast credit losses – in other words, to “run the business”. And there are numerous tools used in the industry to help accomplish this – custom scores, bureau scores, bankruptcy scores, behavior scores, etc. As an example, a certain portfolio may have behavior scores that are refreshed monthly to incorporate the most recent customer payment and usage patterns. It may be redundant to require the inclusion of “delinquency status” by itself into the equation (since it is implicit in the score itself).
- We agree in principle that **Retail risk weights should be much lower than Corporate risk weights for given PD/LGD pairs.** (The draft Accord mentioned the industry survey where it was felt that risk weights for retail should be approximately half of commercial’s, due to much higher diversification for retail.)
- Regarding requirements for estimation of risk components, the draft Accord states that “the length of the underlying historical observation period used should be at least 5 years”. **This 5-year requirement may be excessive in the Retail arena,** where (unlike Corporate, and its 7-year requirement) there are large samples of actual losses to be observed and analyzed every year. This creates huge cross-sectional efficiencies when evaluating losses by segment over a 3-4 year period. Therefore, we believe the 5-year requirement should be investigated further.
- **We do see value in the creation of an industry-pooled database, which would clearly help institutions that do not have a full history of internal data.** In reality, Fair, Isaac’s (and Credit Bureaus) databases, which are used to calculate credit scores, are industry-pooled databases. And the odds ratios associated with Fair, Isaac’s scores are based on much larger samples and are as widely accepted as Moody’s transition probability matrices on the Corporate side.

- Consistent with Corporates, **we believe there could be a Foundation IRB approach for Retail**, where LGD values for each product type would be specified by the regulators. The commonly used industry odds ratios could be a proxy for PD in such a Foundation IRB approach.
- **We are aware that the Models Task Force is planning to publish an updated Retail paper sometime in July.** We are hopeful that our commentary (as well as the rest of the industry's comments) is considered, as this new document is being prepared.

OPERATIONAL RISK

- We appreciate that the Consultative Paper explicitly recognizes operational risk as a major component of risk in the banking business, alongside credit risk and market risk. In proposing an explicit charge for operational risk, the Basel Committee on Banking Supervision has **heightened the importance for banks to build and implement operational-loss-data-collection methodologies** and use the resulting databases to actively manage operational risks.
- To calibrate the parameters for the Standardized Approach and the basic Indicator Approach, the Consultative Paper suggests using a normalization, tantamount to the assumption that, on average, banks keep 20% of their current (1988 accord) minimum required capital as a charge for operational losses. The assumption is based on a survey of a small number of banks which indicates that typically operational loss accounts for 20% of economic capital. The **data** reported by the surveyed banks may **not relate to event-related operational losses only** but to operational risk in general, and is perhaps inclusive of "other" risks. As such the figure of **20% may be an over-estimate**. We hope that for the purposes of calibrating the capital factors, the Committee would increase the survey size and it would strictly filter the data to allow consideration of only event-related operational losses.

Extending the survey to a much larger number of banks may also change the factor α in the Basic Indicator Approach from its provisional value of 30% to a significantly different value.

- In introducing an explicit capital for operational risk, the Committee points out that the goal is to maintain the aggregate regulatory capital during the transition from the 1988 Accord to the New Accord. Since no change in the handling of market risk is proposed, the implication is that the increase in capital due to operational risk will be offset by a corresponding decrease in credit risk capital. While this may be true when the Advanced Internal-Ratings-Based Approach is used for credit risk, it is not likely to be true when the Standardized Approach is used for credit risk. Consider a bank with a large corporate portfolio made up primarily of middle market (unrated) borrowers. The capital charges under the Standardized Approach for credit risk is likely to be similar to the charges under the 1988 Accord. The capital requirement for Operational risk will **increase the aggregate regulatory capital by about 20%**.

- The scarcity of operational loss data is heightened when more advanced methods, like the Internal Measurement Approach, are considered. It is important that banks be allowed to use **industry-pooled data**, in addition to internal data, when calculating parameters for the Internal Measurement Approach. This need has been recognized by the Committee.
- Although the framework of the advanced methods for operational risk capital is similar in spirit to that of the advanced methods for credit risk capital, the data availability is far less and the level of modeling is more primitive in the case of operational risk. As such, **it should be permissible for a bank to opt for the Advanced Internal-Ratings-Based Approach for credit risk while still using the Standardized Approach for operational risk.**
- The frameworks for the different approaches for Operational risk capital need further work in order to firm up the parameters in each of the approaches that will ultimately drive the actual capital numbers. We look forward to continued dialogue and participation with the industry as each of the Operational risk methodologies continue to evolve.

SECURITIZATIONS

- We have received the 4/17/01 industry draft titled “Considerations regarding the IRB Treatment of Securitizations”. **We have worked with the RMA group in developing an initial response, and will continue to devote time to Securitizations in the post-5/31 comment period.**

GENERAL

- In our March, 2000 response to the June, 1999 Consultative paper, we suggested a schematic diagram (below) of the progression from 'standardized approach' to 'IRB approach' to 'internal models based approach'. We would request the Basel Committee to consider the possibility of allowing a full-blown internal models based approach (last column of the diagram) – thus fully aligning regulatory capital with internal economic capital, for advanced practice banks. This would, of course, place even more emphasis on Pillar II supervision.

Standardized Approach (1)	Standardized Approach (2)	Standardized Approach (3)	IRB (1)	IRB (2)	IRB (3)	IRB (4)	IRB (5)	Full Internal Models Based
	Standardized EDF	Standardized EDF	Internal Model EDF	Internal Model EDF	Internal Model EDF	Internal Model EDF	Internal Model EDF	Internal Model EDF
		Standardized LGD based on collateral type	Standardized LGD based on collateral type	Internal Model LGD	Internal Model LGD	Internal Model LGD	Internal Model LGD	Internal Model LGD
		Standardized LEQ	Standardized LEQ	Standardized LEQ	Standardized LEQ differentiated by EDF	Internal Model LEQ	Internal Model LEQ	Internal Model LEQ
Standardized Capital* (one size fits all)	Standardized Capital* differentiated by EDF	Standardized Capital* differentiated by above	Standardized Capital* differentiated by above	Standardized Capital* differentiated by above	Standardized Capital* differentiated by above	Standardized Capital* differentiated by above	Standardized Tenors	Internal Correlation Assumptions
implied correlation assumption							Standardized Capital differentiated by above	Internal Tenors / Durations
								Internal Capital