CHANGING TIMES mean improved

As our nation's central bank, the Federal Reserve is responsible for the integrity of the financial system and views risk management as a key element of bank supervision. Mike Collins, senior vice president, Supervision, Regulation and Credit, tells how Philadelphia is establishing advanced approaches to quantifying retail credit risk.

As a regulator and supervisor of financial institutions, the Fed must expand its knowledge of the broad financial industry to ensure its integrity and stability. The Philadelphia Fed is leading a Systemwide effort to develop a supervisory framework to evaluate bank practices in retail credit risk management, including internal risk rating systems.

This project, which will enhance the Federal Reserve's ability to assess banking organizations' retail credit risk quantification methods, responds to gaps in the Basel II framework. Basel is a landmark international agreement on bank capital standards and risk-based regulation. Until quite recently, bank and supervisory resources have concentrated on credit risk modeling of commercial and industrial portfolios, with fewer resources devoted to understanding risk in the retail credit area, which includes such common consumer instruments as mortgages, credit cards, and auto loans.

However, despite the emphasis on the commercial side, retail credit is a substantial part of the risk borne by the banking industry. Recognizing this, the industry has begun to develop more sophisticated credit-scoring models for measuring retail risk.

DEVELOPING RETAIL CREDIT RISK MODELS

The revolution in information and communications technology has led to the emergence of consumer credit-scoring models as a mainstay technique. As a result, we now have more efficient means to slot individual loans into appropriate risk classes. This has led to greater potential for risk-based pricing and targeted marketing in retail lending; however, there is much ground still to be covered.

While the sophistication of automated credit scoring has increased, only recently have some institutions put resources into advanced methods of retail portfolio credit risk modeling. Additionally, quantifying the risk in retail portfolios places an even greater premium on a bank's ability to accurately differentiate the credit quality of borrowers. It also requires an acute understanding of the contributions of retail credit to both risk and return. For example, problems in accurately predicting performance in sub-prime portfolios proved detrimental to some institutions' overall level of risk, as we have seen in 2002.

THE PHILADELPHIA FED'S PROJECT

Given the recent developments in the retail sector, regulators must gain a greater understanding of current industry practices and areas for potential improvement. The Philadelphia Fed has distinguished itself as an expert hub of emerging industry issues and a vital resource in identifying and implementing industry best practices. Consequently, we have the important System responsibility to expand the Fed's knowledge of advanced approaches to quantifying retail credit risk. Our efforts focus on three main goals:

First, we document existing policies and practices among institutions capable of effectively measuring retail credit risk. Toward this goal, we have joined with other U.S. regulators in conducting interviews at several large banking organizations. These interviews help us identify current practices in evaluating retail credit risk and improve our knowledge of current industry practices. We are using this information to compare banks' current practices with the Basel II proposal for an internal ratings-based (IRB) approach to retail credit.

Michael E. Collins, Senior Vice President and Lending Officer

practices and increased responsibilities

Our second goal is to analyze the reliability of current practices and assess their weaknesses or gaps. That way, we can spot problems supervisors need to address in assessing internal risk and capital adequacy in the retail credit area.

Our third goal is to identify major analytical issues in quantifying retail credit risk and to generate relevant research. In this way, we can identify priority policy issues for the Federal Reserve and other banking regulators and make recommendations on how to tackle them. Philadelphia's work is the beginning of a necessary and important long-term effort in the retail credit arena.

Throughout 2003, Philadelphia will develop a research agenda on retail credit risk quantification. We are now preparing research analyzing strengths and weaknesses of existing retail risk quantification standards at large U.S. banks. Our findings will be presented at various forums to educate the industry on these issues. We will also lead efforts of the Federal Reserve System and other U.S. banking regulators to develop training curricula for supervisory staff on IRB standards and examination guidance.

Constructive dialogue between financial institutions and their regulators means standards progress and practices improve. With more experience and better information, risk parameters will change and models will get stronger and more efficient. Rather than a uniform regulatory standard, financial institutions will develop their own assessments and procedures that accurately capture retail credit risk.