

Clients & Friends Memo

Statement of U.S. Bank Regulators on Implementation of Basel II Framework

February 7, 2005

On January 27, 2005, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency and the Office of Thrift Supervision (together, the “Agencies”) issued an Interagency Statement (the “Statement”) reporting on continuing efforts in the United States to develop and implement regulations based on the Basel Committee on Banking Supervision’s¹ “International Convergence of Capital Measurement and Capital Standards: A Revised Framework” (the “Revised Basel Accord” or the “Framework”). The Revised Basel Accord sets forth a model set of capital adequacy guidelines that are intended for use by regulators and banking organizations both in the countries represented on the Basel Committee and elsewhere.

Although the Statement is primarily directed at the implementation process for the Framework’s capital rules, which will affect only the largest US banking organizations, it is careful to point out that the Agencies anticipate adopting modifications to their current risk-based capital rules in a timeframe that will allow them to take effect at the same time as the Framework-based rules take effect. Presumably, this will reduce the competitive differences between the largest banking organizations that will adopt the Framework-based rules and the multitude of banking organizations that will continue to be subject to the existing risk-based capital rules. The Statement also points out that the Agencies expect that the current (non-risk based) leverage ratio will remain in effect for all banks, ensuring a common floor on capital for large and small banks alike. Also, to allay criticisms that the Agencies have focused primarily on the Framework implementation efforts of the largest banking institutions as to which the new rules will be mandatory, the Statement provides assurance to the so-called “opt-in” institutions that the Agencies will provide assistance to them on an equal basis.

¹ The Basel Committee on Banking Supervision is a committee of banking supervisory authorities which was established by the central bank governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States. It usually meets at the Bank for International Settlements in Basel, where its permanent Secretariat is located.

In their initial response to the Revised Basel Accord, in June 2004², the Agencies stated that the Revised Basel Accord would form the basis upon which revisions to their existing risk-based capital adequacy regulations would be developed. The Statement is part of an effort by the Agencies to continue to provide information relating to the process for implementing the Revised Basel Accord in the United States. In particular, the Statement focuses on (i) the appropriate scope and timing of the implementation plans that will be required of United States institutions that are obligated or that intend to apply the advanced calculation methodologies contemplated by the Revised Basel Accord, and (ii) the qualification process that the Agencies will use to determine an institution's eligibility to use such methodologies.

I. Qualification Process and Expected Timeline

Subject to regulatory approval from each institution's primary regulator, the Revised Basel Accord will permit sophisticated banking institutions to calculate their capital requirements by using certain "advanced approaches": the internal-ratings based approach ("IRB") for measuring credit risk and the advanced measurement approaches ("AMA") for operational risk. The Agencies expect to adopt regulations that implement the advanced approaches for use by eligible United States institutions. However, not all United States institutions will be required or permitted to use the advanced approaches. The Agencies have instead stated that they expect to require only a small number of the largest United States banking organizations to use the advanced approaches. Other United States institutions may elect - but will not be required - to use the advanced approaches after the implementing regulations become effective. In all cases, however, institutions will not be permitted to use the advanced approaches unless they have (i) submitted to their primary regulator an implementation plan detailing the process by which they will convert to the new capital calculation methods, and (ii) received from their primary regulator specific approval to use the new methods. As discussed below, the Agencies also expect any institution that intends to switch to the advanced approaches to calculate its capital requirements under both the Agencies' existing capital regulations and under the advanced approaches for a one-year "parallel run" period before moving exclusively to the advanced approaches.

The Agencies state in the Statement that the development and implementation of the regulations, systems, processes and methodologies needed to implement the Revised Basel Accord will pose enormous timing challenges for both the Agencies and banking institutions. The Agencies therefore have provided in the Statement an expected implementation timeline. As set forth by the Agencies in reverse chronological order, the timeline provides as follows:

² The Basel Committee approved the Revised Basel Accord on June 26, 2004. The Agencies' initial response to the Revised Basel Accord is detailed in a Clients and Friends memorandum dated July 2, 2004, and can be found in a printable version at www.cwt.com.

- January 2008 – Effective date of the final regulatory framework;
- January 2007 – First opportunity to “parallel run” the current framework with the proposed regulations;
- Mid-year 2006 – Publication of the final regulations and updated guidance; and
- Mid-year 2005 – Publication of the notice of proposed rulemaking on possible revisions (“NPR”).

The Agencies state in the Statement that a number of institutions have expressed interest in taking tangible steps toward qualification in advance of the publication of final rules and guidance so that they may use the advanced approaches at the earliest possible date. The Agencies further state that they are ready to work with any institutions that elect to make such preparations; and that they consider the development of detailed written implementation plans for the IRB and AMA to be among the most significant steps that any such institution could take prior to the approval of final rules.

II. Implementation plans

The Statement states that each institution's implementation plan will be a critical feature in its application for approval to use the advanced approaches. The implementation plans will link existing Agency guidance with the institution's specific implementation activities and provide an initial basis for the development of supervisory plans related to the qualification process. The Statement states that the implementation plans should be approved by the board of directors of the relevant institution and discussed by the institution with its primary federal regulator. It further states that the board of directors and senior management at each institution have an obligation to understand the institution's risk profile and to ensure that those risks are properly managed and that the institution maintains adequate capital in respect of those risks.

The Statement lists the following objectives for the use of implementation plans in the qualification process:

- Implementation of the advanced approaches, including decisions relating to IRB and AMA qualification, should be “normalized” into the supervisory process of the Agencies. On the part of the Agencies, this “normalization” will also involve the increased use of a diversity of skill sets in a day-to-day supervision, especially including those of quantitative experts.
- The qualification of institutions for the IRB and the AMA will be an iterative, on-going process. The Agencies intend to assess individual IRB and AMA methodologies through numerous discussions, reviews and examination activities. The Agencies also recognize the critical importance of on-going validation of IRB and AMA methodologies subsequent to initial qualification decisions.

- Implementation plans will serve as a critical communication instrument between institutions, their home country and various host-country supervisors. However, the Agencies state that neither the Revised Basel Accord, nor any implementing regulations, alter the legal responsibilities of home or host supervisors.
- Each of the Agencies expects to incorporate implementation plans into its quality assurance efforts to ensure consistent application of the new regulatory framework across institutions, while ensuring that the confidentiality of supervisory information is maintained. The Agencies expect to utilize each institution's own self-assessments and remediation steps (described below) to facilitate peer analyses and to take necessary steps to improve consistency of application and comparability of results.
- The Agencies expect to propose that the development of an effective implementation plan is a necessary – but not a sufficient – condition of the qualification process. Ultimately, full qualification will depend on successful execution of the implementation plan and actual operation of IRB and AMA systems consistent with supervisory standards.

The Agencies further state that they will propose in the NPR that institutions wishing to adopt the Framework-based regulations should take the following actions:

- Adopt implementation plans that:
 - ◇ include self-assessment by the institution of its current status in meeting qualification standards of the Agencies;
 - ◇ contain a gap analysis, based on the result of the institution's self-assessment, that identifies and describes the areas in which it needs to undertake additional work;
 - ◇ include a remediation (or action) plan describing the manner by which the institution would address the areas identified in the gap analysis and undertake the necessary work to resolve shortcomings;
 - ◇ identify objectively measurable milestones, including delivery dates;
 - ◇ demonstrate that adequate resources would be realistically budgeted and made available;
 - ◇ receive board of director endorsement and approval at each institution; and
 - ◇ form the basis for regular discussion with the primary federal regulator.
- Develop and maintain a comprehensive and sound planning and governance process to oversee the implementation efforts and to support development of tangible plans for IRB and AMA.

- Adopt IRB and AMA implementation plans that are comprehensive, addressing the implementation requirements for all relevant legal entities, whether they are U.S. or foreign based, including a description of all required supervisory approvals. In this regard, the Statement states that institutions adopting framework-based regulations would have to apply IRB and AMA across all material business lines, portfolios and geographic regions. Exposures in non-significant business units, as well as asset classes that are immaterial in terms of size and perceived risk profile, may be exempted from the IRB and AMA only with approval of the primary federal regulator.

The Agencies previously issued in draft form three significant pieces of supervisory guidance relating to the implementation of the Revised Basel Accord – Corporate IRB, Retail IRB and AMA. The Agencies also are currently engaged in a fourth quantitative impact study ("QIS-4") to evaluate the potential effects of implementing the Revised Basel Accord in the United States. In light of the goals listed above, the Agencies' prior release of draft supervisory guidance and the Agency feedback that will be available to institutions that submit information to them under QIS-4, the Agencies in the Statement urge institutions which expect to adhere to Framework-based regulations on or near the effective date in 2008 to move forward with their efforts and begin development of tangible IRB and AMA implementation plans at the earliest possible date. The Statement states that, in order to help ensure adequate time for supervisory review of its implementation plans prior to the effective date, each interested institution should provide an initial iteration of its implementation plans to its primary federal regulator by the third quarter of 2005.

III. Notification Process

As previously announced by the Agencies in August 2003, the Agencies state in the Statement that they intend to propose that the United States have a bifurcated regulatory capital regime after the Revised Basel Accord is implemented. Specifically, the Agencies expect two distinct methodologies to be available for the calculation of regulatory risk-based capital requirements – one based on the Revised Basel Accord and another using an updated version of the Agencies' existing capital adequacy regulations. A limited number of large, sophisticated institutions would (as mentioned above) be required by the final rules to apply the Framework-based regulations; other institutions would be permitted, but not required, to request approval to use such regulations. Also as mentioned above, the Agencies expect the leverage ratio to remain in effect for all banks.

The Agencies further state in the Statement that they expect to require any institution that intends to use the Framework-based regulations to provide formal notice of such intention to its primary federal regulator at least 18 months before the expected changeover date. As discussed below, this timeframe will permit the institution to undertake the required one-year parallel run of calculation methodologies. The Statement states that the institution's notice should set forth a proposed timeframe for its adoption of IRB and AMA methodologies, and could also incorporate any documents previously provided to the Agencies, including IRB and AMA implementation plans.

The Agencies state that they expect the primary regulator to respond to the notice during the institution's parallel run period and communicate the decision as to whether the institution is approved to make use of IRB and AMA methodologies in the calculation of its regulatory capital requirements.

The Agencies state that institutions wishing to opt-in into the Framework-based regulations will be subject to the same qualification requirements that apply to institutions subject to mandatory compliance, including the requirement to give proper prior notice to the institution's primary federal regulator. The Statement notes that each "opt-in institution" would be permitted to delay or abandon its implementation efforts at any time before it is fully qualified. Finally, the Agencies state that they expect to consider possible changes to the risk-based capital regulations for U.S. institutions that are not subject to the Framework-based regulations in a timeframe that would allow them to become effective at the same time as the Framework-based regulations.

IV. Parallel Running

The Agencies expect to require each institution that is obligated, or that elects, to use the Framework-based regulations after they become effective to calculate its regulatory capital requirements under both the Agencies' existing capital regulations and the Framework-based regulations (a "parallel run") for at least one full year before the institution will be permitted to base its capital calculations solely on the Framework-based regulations. The parallel run of the capital calculations must be undertaken in a manner acceptable to the institution's primary federal supervisor. During the parallel run period the institution's calculations under the Agencies' existing capital regulations will constitute the controlling calculations. Accordingly, an institution that intends to apply IRB and AMA methodologies beginning in 2008 would need to have fully implemented the necessary systems for use throughout 2007, including appropriately addressing all remedial actions previously identified by supervisory staff. The Statement states that the parallel run procedures will allow the institution's primary federal regulator to observe those systems in actual operation and will provide useful quantitative information about the revised regulatory capital requirements during the period prior to their first use for regulatory capital purposes.

The Agencies intend the supervisory review of the parallel run process to provide the basis for qualification decisions by the primary federal supervisor. An affirmative qualification by the primary supervisor will be required for an institution to be allowed to use IRB and AMA results on a going-forward basis. The Statement notes that there is no specific approval required to begin parallel running. Institutions would be required during the parallel run period to report the results of their IRB and AMA systems to their primary federal regulator on a quarterly basis. Such information would be kept confidential in accordance with applicable law. At some point during the parallel run period, the primary federal regulator will notify the institution whether or not it is approved to use the IRB and AMA approaches.

V. Next Steps

The Agencies state in closing that they intend to provide further information on the proposed IRB and AMA qualification process in the forthcoming NPR. They further state that, in the meantime, the Agency staffs are willing to meet with any institution that wants to discuss methods of enhancing current IRB and AMA systems and processes and that the Agencies stand ready to provide information and assistance to all institutions that are required (or that intend) to observe the Framework-based regulations.

If you have any questions regarding the Statement or the Revised Basel Accord generally, please contact Jim Croke at (212) 504-6139, Peter Manbeck at (212) 504-6626 or Larry Fruchtman at (212) 504-6859.