

Clients & Friends Memo

Basel II/Joint Press Release of U.S. Banking Regulators: U.S. Regulatory Response to the Release of Basel II

July 2, 2004

On June 26, 2004, 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 a joint press release (the "Release") in response to the release by the Basel Committee on Banking Supervision¹ of its "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" (the "Revised Basel Accord"). The Revised Basel Accord replaces the existing Basel Capital Accord. It sets forth a model set of capital adequacy guidelines that – subject to implementation in individual jurisdictions – are intended for use by regulators and banking organizations both in the countries represented on the Basel Committee and elsewhere. In the Release, the Agencies summarize the actions they expect to take in response to the Revised Basel Accord.

The Agencies state in the Release that the Revised Basel Accord will form the basis upon which they develop future proposed revisions to their existing risk-based capital adequacy regulations. They have also confirmed that only a small number of large, internationally active U.S. banking organizations will be required to use the Revised Basel Accord, and that those institutions would use only the most advanced approaches for determining their risk-based capital requirements. Subject to supervisory approval, other U.S. banking institutions could adopt the Revised Basel Accord's advanced approaches on a voluntary basis.

The Agencies state in the Release that they have developed a comprehensive plan to incorporate the advanced risk and capital measurement methodologies of the Revised Basel Accord into regulations and supervisory guidance for U.S. institutions. This plan is intended to ensure that U.S. implementation efforts are consistent with the Revised Basel Accord; that they reflect the unique

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.

statutory, regulatory and supervisory processes in the United States; and that they seek and consider comments from interested parties.

The Agencies expect that institutions using capital measurement approaches based on the Revised Basel Accord will, prior to implementation, first be subject to a year of “parallel running”; i.e., application of the advanced approaches in tandem with the current risk-based capital regime, beginning in January 2007. The Agencies further expect that the Revised Basel Accord would become fully effective in the United States for the relevant institutions in January 2008. The Agencies are planning to apply prudential floors to risk-based regulatory capital calculations in the two years immediately after adoption of the Revised Basel Accord. Qualified institutions that opt in to the Revised Basel Accord subsequent to the initial implementation period would be subject to a similar phase-in schedule.

As banking organizations that use the Revised Basel Accord's advanced approaches will likely need to make significant infrastructure investments, the Agencies state in the Release that it would be prudent for organizations that expect to adopt those approaches on or near the effective date to begin planning their implementation efforts now.

Supervisory Guidance

The Release states that the Agencies are developing supervisory guidance in relation to various portfolios and risk exposures addressed by the Revised Basel Accord. This guidance is intended to provide U.S. institutions and supervisors with a clear description of the essential components and characteristics of the measurement and management structures for those risks and to describe relevant supervisory expectations for banking organizations that use the Revised Basel Accord advanced approaches to calculate their capital requirements.

The Release advises institutions that expect to adopt the Revised Basel Accord approaches to study the Agencies' draft supervisory guidance as they develop their implementation plans and, in particular, to consider whether their existing systems and processes comply with or differ from the proposed supervisory standards. The Agencies also state in the Release that they expect to publish additional information regarding the process that will be used to assess the efforts of individual institutions to meet the applicable standards.

Quantitative Impact Study

The Agencies will later this year conduct a fourth Quantitative Impact Study ("QIS-4") to evaluate the potential effects of a U.S. implementation of the Revised Basel Accord. Although other countries may undertake joint or independent reviews similar to QIS-4, the Agencies state that QIS-4, as implemented in the United States, will be tailored to the domestic interests of the Agencies and will focus on the effect of the Revised Basel Accord on U.S. banking organizations, especially those large, internationally active institutions that the Agencies intend to require to follow the Revised Basel Accord. Other institutions that anticipate using the Revised Basel Accord approaches on a voluntary basis may also participate in the study in order to understand better the nature of the internal risk measurement information that the new rules would require and to estimate their resulting capital requirements. The Agencies state that a full or partial recalibration of the Revised Basel Accord approaches (as implemented in the United States) may be considered based on the results of QIS-4.

Revision of Capital Adequacy Regulations

The Agencies note in the Release that, under the arrangements proposed for the implementation of the Revised Basel Accord in the United States, some U.S. banking organizations will use the Revised Basel Accord's most advanced approaches to determine their risk-based capital requirements, while others will continue to apply the existing U.S. capital rules. As a result, the United States would have a bifurcated regulatory capital framework. In conjunction with their evaluation of the U.S. risk-based capital guidelines that will apply to those banking organizations that apply the Revised Basel Accord's advanced approaches, the Agencies are also considering possible changes to the capital regulations for U.S. institutions that will not be subject to the Revised Basel Accord approach.

The Agencies expect to publish in mid-2005 proposed changes to their risk-based capital adequacy regulations to implement the Revised Basel Accord advanced approaches. After allowing time to review comments received on the rule proposal, the Agencies state that they expect to be in a position to publish final implementing rules in the second quarter of 2006. Possible changes to capital regulations for U.S. institutions not subject to Revised Basel Accord-based regulations will be considered in this same general timeframe.

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