



National Regulatory Advisory Services

Regulatory Practice Letter

ADVISORY

RPL Number 05-08

Recent News on Basel II Capital Accord and U.S. Implementation

Executive Summary

Banks affected by the New Capital Accord (commonly referred to as "Basel II") proposed by the Bank for International Settlements' Basel Committee on Banking Supervision ("Basel Committee") should be aware of several recent developments affecting the framework and implementation of the new rules, including: an accelerated timetable for a fifth quantitative impact study; approaching implementation issues; new proposals for the treatment of double default and trading activities; and, a delayed release of the notice of proposed rulemaking for the new US capital regulations that had been expected to be issued over the summer of 2005.

QIS 5:

In March 2005, the Basel Committee announced plans to undertake a fifth quantitative impact study ("QIS 5") of the effects of the proposed Basel II capital rules. The QIS 5 will occur between October and December of 2005, which is three months earlier

than previously expected. Similarly, the Basel Committee announced that it intends to accelerate its review of the calibration of Basel II to the spring of 2006.

The Basel Committee stated that it believes the earlier date for potential recalibration of the framework will provide banks with more time to study the expected effects of the Basel II rules and aid implementation plans. In countries in which a fourth quantitative impact study ("QIS 4") has been conducted (e.g., the US), the QIS 5 might be either a partial update of QIS 4 or a new exercise. The Basel Committee has indicated that banks will be provided with draft workbooks for the QIS 5 in July 2005.

Basel II Implementation Issues:

In a March 31 address to the Annual Meeting of the Financial Services Roundtable, Federal Reserve Board Governor Susan Schmidt Bies commented that, "Substantial work remains to be done before Basel II can go live." She cited data collection and

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As Issued By:

Various Entities

Date:

May 20, 2005

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validation as good examples of areas where substantially more needs to be accomplished and she encouraged banks to continue their efforts on these fronts, as US supervisors are working diligently to provide guidance on what they expect. Further, Governor Bies encouraged bankers to initiate a dialogue with their supervisors concerning Basel II implementation. Her remarks were closely aligned with the *Interagency Statement - US Implementation of the Basel II Framework*, which was released in January by the Federal Reserve Board, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation and the Office of Thrift Supervision (collectively, the "Banking Agencies").

Proposed Treatment of Double Default and Trading Activities:

On April 11 the Basel Committee and the International Organization of Securities Commissions ("IOSCO") jointly issued a paper for public comment outlining proposed capital requirements for banks' exposures to certain trading-related activities. This included a treatment for counterparty credit risk, as well as a proposed solution for double default effects, or the risk that both a borrower and guarantor default on the same obligation.

The paper, which was entitled *The Application of Basel II to Trading Activities and the Treatment of Double Default Effects*, described a proposal to

address the following five specific issues:

- The treatment of counterparty credit risk for over-the-counter derivatives, repo-style and securities financing transactions; and the treatment of cross-product netting arrangements;
- The treatment of double-default effects for covered transactions, in relation with trading book, but also banking book, exposures;
- The short-term maturity adjustment, in the internal ratings-based approach;
- Improvements to the current trading book regime, especially with respect to the treatment of specific risk; and
- The design of a specific capital treatment for unsettled and failed transactions.

The Basel Committee and IOSCO welcome comments through May 27. This schedule will accommodate time constraints associated with national rulemaking processes so that final rules may be released in summer 2005.

US Agencies Delay Release of Notice of Proposed Rulemaking:

On April 29, the Banking Agencies announced that they planned to delay their publication of a notice of proposed rulemaking ("NPR") related to Basel II. The Banking Agencies had intended to publish the NPR around mid-year 2005 but have delayed so that they may better assess the results of the QIS 4, which was completed in January. The

regulators disclosed that the QIS 4 submissions evidence material reductions in aggregate minimum capital requirements for the population of approximately 30 banks that participated in the study. In addition, individual minimum capital requirements varied widely among institutions and according to portfolio types.

On May 11, Susan Schmidt Bies, Federal Reserve Board Governor, Julie L. Williams, Acting Comptroller of the Currency, Thomas Curry, Director of the Federal Deposit Insurance Corporation, and Richard M. Riccobono, Acting Director of the Office of Thrift Supervision, each testified before Congress on the U.S. implementation of Basel II, the results of the QIS 4, and the reasons for the decision to delay the release of the planned NPR. Acting Comptroller Williams stated that the aggregate reduction in minimum capital among QIS 4 participants amounted to 17 percent with a median decrease of 26 percent. Results for individual institutions ranges from a 47 percent decrease to a 56 percent increase in minimum capital calculations. The Banking Agencies have determined that additional analysis is necessary to determine whether these results reflect differences in risk, varying progress toward implementation among survey participants, limitations of the QIS 4 study, and/or suggest necessary adjustments to the Basel II framework.

Despite the delay of the NPR, the Banking Agencies reiterated their commitment to the implementation of

Basel II and encouraged institutions that seek to adopt the Basel II rules at inception to continue with their implementation efforts. Based on the May 11 testimonies, the NPR will likely be released in the 2nd half of 2005, with final rules issued in mid-2006.

On May 19, Federal Reserve Board Governor Susan Schmidt Bies presented the opening remarks at the Federal Reserve System's Conference on *Implementing an Advanced Measurement Approach for Operational Risk*. She indicated that, when released, the NPR would incorporate lessons learned from the QIS 4 results as well as the latest proposal on the trading and banking book as released by the Basel Committee and IOSCO. She added that the Banking Agencies' "reaction to the results of QIS 4 shows how seriously [they] are taking Basel II implementation."

Governor Bies also acknowledged that from the QIS 4 responses, the Banking Agencies see that, although quantitative challenges remain, many institutions are developing sophisticated approaches for measuring operational risk exposures. She added that preliminary analysis of the submissions from the Banking Agencies' loss-data collection exercise show significant progress has been made in the collection of operational-risk data and the quantification of operational risk. Further, the analysis shows that there has been a significant increase in the number of institutions collecting such data over the past five years.

Commentary

Basel II is nearing a number of critical milestones during 2005 and many banks will be challenged to keep pace. As the new US capital regulations and implementing guidance are finalized, both mandatory and first-phase opt-in institutions will need to incorporate final standards and guidance, continue their individual development of data collection and warehouse needs, validation and other attendant risk management processes, and simultaneously address a challenging business and competitive environment.

Implementation is expected to be a long and complex process. The Banking Agencies have observed that it will require a great deal of planning and communication between adopting institutions and their primary regulators. Qualification will be an iterative process that has, to some extent, already begun in the mandatory banks and which will place substantive demands on adopting banks as the process progresses through January 2008. The Banking Agencies expect mandatory, as well as opt-in, Basel II banks to have a detailed implementation plan, with a clearly defined framework of roles and responsibilities, including board of director endorsements, to be in place and ready for discussion this year. In addition, banks are expected to have completed their initial gap analysis relative to the proposed standards and guidance for supervisory review.

While the publication of a US NPR for Basel II implementation has been delayed, the Banking Agencies have

reiterated their commitment to updating US capital regulations to incorporate the agreed-upon Basel II framework. It is essential that adopting banking institutions, whether mandatory or opt-in, do not lose momentum in the face of the delayed NPR. In fact, the delay of the US NPR may be viewed as an opportunity for US institutions to step up their dialogue with regulators to help influence the final capital rules, which the Banking Agencies still plan on becoming effective on January 1, 2008. The planning and dialogue will be even more critical as there will now be a compressed lead-time between the release of the NPR, the implementation of the final rules, and the 2007 parallel run year.

Banks' Directorates and managements should also note that the testimonies of Governor Bies and Acting Director Riccobono each included comments on the importance of maintaining the minimum leverage ratio and Prompt Corrective Action facets of FDICIA (the *Federal Deposit Insurance Corporation Improvement Act*) as critical components of a prudent supervisory regime. Each also cited the need for institutions to maintain capital in excess of the minimum requirement, which we infer suggests that this will be addressed under evolving guidance for Pillar 2 (supervisory review). Lastly, both Governor Bies and Acting Director Riccobono expressed the need to modernize the current capital regime for "non-Basel II" organizations and expect a proposal on this topic could be issued simultaneously or shortly after the NPR for Basel II.

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