



U.S. Implementation of Basel II: An Overview

May 2003

Objectives of the Revisions to the Basel Accord

- Advance a “three-pillar” approach
 - Pillar 1 -- minimum capital requirement
 - Pillar 2 -- supervisory oversight
 - Pillar 3 -- heightened market discipline
- Develop a measure of capital that is:
 - more risk sensitive than the current approach
 - better suited to the complex activities of internationally-active banks
 - capable of adapting to market and product evolution

Objectives of the Revisions to the Basel Accord (cont'd)

- Encourage improvements in risk management and enhance internal assessments of capital adequacy
- Incorporate an operational risk component into the capital charge (to correspond with the unbundling of credit risk)
- Heighten market discipline through enhanced disclosure

Revised Basel Accord

- Two approaches developed for calculating capital minimums for credit risk:
 - Standardized Approach (essentially a slightly modified version of the current Accord)
 - Internal Ratings-Based Approach (IRB)
 - foundation IRB - supervisors provide some inputs
 - advanced IRB (A-IRB) - institution provides inputs
 - underlying assumption is a broadly diversified portfolio -- by both product and geography
 - qualifying standards will be rigorous

Revised Basel Accord (cont'd)

- Three methodologies for calculating capital minimums for operational risk
 - Basic Indicator Approach
 - Standardized Approach
 - Advanced Measurement Approach (AMA)
 - use of AMA subject to supervisory approval
 - rigorous quantitative and qualitative standards
 - internal and external data requirements
 - ability to capture impact of low-frequency, high severity loss events
- Third consultative paper (CP3) just released

Implementation in the United States

- U.S. supervisors only intend to adopt the A-IRB approach for credit risk and the AMA approach for operational risk
- Banks not subject to Basel II continue to apply the existing domestic regulatory capital rules
 - current charges include buffer for other risks
 - consistent with principles underlying three pillars of Basel II
 - current rules may change over time
- U.S. banking agencies are working closely together in preparation for Basel II

Timeline for U.S. Implementation

- Comment period on CP3 (May-July 2003)
- Release of draft supervisory guidance for corporate IRB and operational risk (July 2003)
- Publication of ANPR (July 2003)
- Further development of draft supervisory guidance for other portfolios (fall 2003)
- Finalization of revised Accord (year-end 2003)
- Issuance of NPR (1Q 2004)
- Final Rule (2Q-3Q 2004)
- Completion of supervisory guidance (mid-2004)

Issuance of ANPR

- Based on CP3, tailored for U.S. implementation
- Will describe U.S. capital rules incorporating Basel II concepts
- Will describe scope of application and criteria for identifying mandatory banks
- Supplemental guidance will describe U.S. qualifying standards
- Will point to areas on which the agencies are seeking specific comments
- Agencies strongly encourage detailed comments
- Based on reaction to ANPR, supervisors will seek changes to the Accord proposal

Treatment of Mandatory Banks

- Core set of banks (mandatory banks)
 - Agencies are developing criteria to identify core set of banks
 - criteria are based on asset size, foreign activities
 - currently encompass about ten banks
- Mandatory banks comprise large, internationally-active U.S. banks
- Mandatory banks are expected to be working towards adoption of the A-IRB approach and AMA at the *earliest possible date* after December 31, 2006

Mandatory Banks (cont'd)

- Mandatory banks will be expected to conduct a comprehensive self-assessment and develop a detailed action plan to implement A-IRB/AMA
 - Plans must be acceptable to supervisors
 - Plans must have measurable intermediate goals
 - Plans must reflect approval of adequate resources
 - Plans should be developed no later than 4Q 2004
- Mandatory banks will adopt A-IRB/AMA regulatory capital regime only when they are ready - emphasis is on getting it right, not just on time
- Failure to keep pace with action plan could result in supervisory sanctions

Mandatory Banks (cont'd)

- Agencies continue to encourage banks to improve existing risk management systems, consistent with current supervisory guidance
- Agencies also recognize the challenges banks face in developing systems and procedures to qualify for A-IRB/AMA, while supervisory expectations about those systems have not yet been fully articulated
- Supervisory guidance for all Basel II portfolios is being developed on an interagency basis

Non-Mandatory Banks

- May operate under current U.S. rules
 - No explicit charge for op risk (embedded in current charge)
 - Subject to periodic revision, as has been the case since 1989
 - Over time, supervisors may consider modifications such as:
 - External ratings for corporates, credit risk mitigation approaches, and higher risk weights for nonperformings
- Or may seek approval to use Basel II A-IRB & AMA
 - Any bank has the option of applying A-IRB and AMA
 - Banks must first meet all applicable supervisory standards
 - Bank systems must be approved by supervisor
 - Will include an explicit op risk capital charge (AMA)

Basel II Considerations

- Under IRB, risk sensitivity means higher (than current) capital charges for riskier assets and lower capital charges for lower risk assets -- a two-edged sword
- Any “opt-in” Basel II banks will also have to conduct a comprehensive self-assessment and develop a detailed action plan
- Opt-in banks will be subject to the same rigorous standards as mandatory banks

Basel II Considerations (cont'd)

- Basel II entails significant costs relating to infrastructure development, data warehousing, disclosure
- Basel II also brings benefits in terms of risk management
- Therefore, non-mandatory banks should weigh all associated costs and potential benefits before deciding to move to A-IRB/AMA
 - Rating agencies indicate they will not “penalize” banks for which Basel II is less appropriate

Basel II Considerations (cont'd)

- Supervisors have agreed to communicate and cooperate to ensure consistent application across countries and minimize burden on institutions
- Treatment of domestic subsidiaries of foreign banking organizations (FBOs) will depend on agreements between U.S. supervisors and home country supervisors
- Agreements are being developed that apply to operations of both U.S. subs of FBOs and to foreign subs of U.S. banks
- As is the case today, banks operating in host countries will have to abide by host country rules (with potential for some flexibility, based on supervisory agreements)

Minimum Requirements for A-IRB and AMA

- U.S. implementation of all standards will be rigorous and thorough. Supervisory guidance that will identify minimum requirements for use of advanced approaches is under development
- Minimum requirements “raise the bar” for risk management practices
- Minimum requirements must be met on an on-going basis. Systems must keep pace with the evolution of industry practice
- The primary regulator, after consultation with other relevant supervisors, has responsibility for determining whether a bank meets the qualifying standards for use of advanced approaches

Transitional Arrangements

- Banks adopting A-IRB/AMA will be required to calculate their capital requirements under both the existing Accord and A-IRB/AMA for one year before moving to A-IRB/AMA
- During the first year of implementation, capital requirements cannot be less than 90% as calculated under the current Accord. In the second year, the floor is 80% of the current Accord
- The two-year period of floors will apply no matter when an institution adopts A-IRB/AMA
- There are currently no plans to change PCA rules₁₇

Summing Up

- Core set of U.S. banks will be required to adopt A-IRB and AMA based on a set of strict qualifying standards
- Non-mandatory banks will have the option of using existing capital rules or adopting advanced approaches
- The same rigorous minimum standards for advanced approaches will be used for all banks
- Non-mandatory banks should carefully consider costs and benefits of advanced approaches