U.S. Implementation of Basel II: An Overview

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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 rules
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