

Regulatory capital developments -- U.S. application and implemen - tation of the Basel 2 framework: what's ahead?



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By Daniel L. Weiss

¹ Source: FDIC Statistics on Depository Institutions Report <http://www2.fdic.gov/sdi> with data as of 3/31/05.

² Banking agencies include: the Board of Governors of the Federal Reserve System (“FRB”), the primary Federal supervisor of US bank holding companies, including those that are designated financial holding companies, and of state chartered commercial banks that are members of the Federal Reserve System, The Office of the Comptroller of the Currency (“OCC”) supervisor of national banks, the Office of Thrift Supervision (“OTS”) supervisor of Federally chartered thrifts and the Federal Deposit Insurance Corporation, primary supervisor of non-member state chartered banks.

³ On May 16, 2005, Federal Reserve Board Governor Mark W. Olson indicated that, “Results from QIS4 were more widely dispersed and showed a larger overall drop in capital than the agencies had expected. This was the impetus for deciding to delay the notice of proposed rulemaking for Basel II. We now have to determine whether these results arose from actual differences in risk among respondents, differences in stages of preparation (including data limitations) among respondents, limits of the QIS4 exercise, or a possible need for adjustments to the Basel frame-work itself.” - Annual Washington Briefing Conference of the Financial Women’s Association, Washington, D.C.

Since the early 1990s, US bank supervisory guidance and regulatory authorities have recognized that the U.S. banking system, and the global financial services sector, have sustained substantial transformation due to market and technological developments. While there are a large number of insured banking institutions, significant consolidation and concentration has occurred. For example, **as of the first quarter 2005, there were approximately 8,930 U.S. based banks and savings associations with \$10.3 trillion in banking assets of which the top 50 banks accounted for approximately 60%.¹** A relatively small number of very large “systemically significant” institutions, with national scope and international activities have emerged, exhibiting operational and organizational complexity and diversification into new activities and financial services and products, particularly in capital markets. The banking agencies and Congress recognized these market developments in legislation and regulation.

In particular, the banking agencies, established a risk-focused examination approach and stepped up inter-agency and sector coordination. In considering the application of the “International Convergence of Capital Measurement and Capital Standards: A Revised Framework,” issued by the Basel Committee on Banking Supervision in June 2004 and generally known as the Basel 2 Framework (“Framework”), the US federal banking agencies have jointly issued guidance and agreed on key principles.² One of these is that the U.S. will have a bifurcated regulatory capital regime after implementation of the Framework.

U.S. Implementation of the revised Framework is expected only to apply to approximately 20 of the country’s largest internationally active banking organizations. These institutions will be required to qualify,

employ and disclose measurement and risk management methods and output for the Advanced Internal Ratings-based approach to credit risk (“A-IRB”) and the Advanced Measurement Approach to operational risk (“AMA”), in addition to current requirements. The institutions comprising the balance of the US banking system will remain subject to the existing U.S. capital adequacy regime, based on the first Basel Capital Accord, with some expected modifications for directional consistency with the U.S. adoption of the Framework. In addition, the leverage capital ratio will continue to apply to all banks and savings associations.

Framework implementation continues to build momentum among supervisors and the large, complex, internationally-active banking institutions that will be subject to the Framework. **U.S. supervisors recently**

noted that results of the fourth quantitative impact study completed in early 2005 indicate the need for further conceptual and data refinements prior to issuing a proposed rule, now anticipated later in the year.³ The agencies are soliciting feedback from various stakeholders in the US banking system, indicating a willingness to address stakeholder concerns, which may well lead to substantive revisions of the Framework and current draft guidance through the rule-making process. Broadly, the current focus includes:

(a) clarification, calibration, and adoption of the Framework through:

- proposed revisions to the existing risk-based capital adequacy regulations
- additional supervisory guidance
- consideration of possible changes to risk-based capital regulations for US institutions not subject to the Framework; and

(b) the process for qualification of the A-IRB and AMA.

Timing is generally perceived as tight for initial implementation; particularly with respect to ensuring data sufficiency as well as development, approval, and integration of the necessary risk and reporting infrastructure, such as systems, processes and methodologies, for qualification of the advanced measurement approaches. *Notwithstanding some uncertainties with the proposed rules, institutions' comprehensive implementation plans and processes are tending to shift from an emphasis on understanding requirements, defining needs and identifying gaps to addressing gaps and design and integration of the needed infrastructure in "business as usual" operations.* The shift prompts more and diverse resources being marshalled within the subject institutions to qualify and fulfill the implementation plans. The banking regulators, too, are integrating specialists into institution-specific dedicated examination teams to ensure responsive tracking and feedback.

This article seeks to provide some perspective on certain topical issues and the state of the US implementation of the Framework applicable to banks as of the Spring 2005. Some of the issues highlighted are being addressed through supervisory coordination while others await clarification of the standards and experience with the Framework once it is "in production". Contemporaneous developments, such as with respect to US and international financial accounting for securitizations and derivatives, reporting taxonomy, and significant efforts that institutions are dedicating to meeting the Sarbanes-Oxley disclosure controls requirements, are also influencing the Framework implementation process and the dialogue around certain of these issues.

Data sufficiency

Data sufficiency is an essential and recurrent implementation focus. Dependencies include clarification of Framework definitions that range from categorization of products/activities to refinement of attributes, measurement parameters and materiality thresholds. From an A-IRB approach, US institutions have introduced granular multi-dimensional credit rating schemes and are accumulating portfolio and transaction histories and loss experience and preparing for sufficient information to back test key factors, such as probabilities of default, exposure at default and loss given default. AMA efforts also progress, particularly in the identification and collection of risk and loss events, and will likely accelerate with further guidance and industry and supervisory consensus on the details of the measurement approaches – and possible mechanisms for sharing loss data for quantitative analysis.

Much effort has been devoted to defining data attributes and mapping for both advanced approaches, prompting increasing dialogue with supervisors on definitions and calibration. For example:

- scoping of equities and retail accounts, such as the definition and treatment of defaulted and unseasoned accounts
- treatment of credit hedges, and:
- access to detail on risk assets managed by others.

Institutions are reviewing their existing systems and management processes that are variously managed on a legal entity, business line, geographic, and/or product basis to ensure appropriate alignment, granularity and accessibility. The mapping efforts include attention to access and accuracy of reference information that facilitate appropriate grouping and categorization of exposures. The data mapping and gap analysis associated with Framework implementation has been contemporaneous with and has generally benefited from compliance with Section 404 Sarbanes-Oxley, particularly with respect to the formalization of systems, processes and controls documentation and facilitating monitoring of operational risk loss events.

"Home/host" oversight

Home/host oversight, local/foreign office implementation and national treatment represent a mix of policy and practical concerns for US and peer supervisors and subject institutions. A number of concerns are being addressed through multiple tracks including among international supervisors via the Accord Implementation Group ("AIG") and through bilateral and supervisory group dialogue, as well as among individual institutions and their home and host regulators. These key concerns include:

- consolidated banking supervision objectives and coordination/harmonization of differences in measurement and reporting requirements for subsidiaries
- the definition of significant subsidiaries
- the treatment of branches and "non-significant" subsidiaries, and:
- the allocation of diversification benefits to subsidiaries.

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In addition to the timing of pending determinations, the home/host dialogue is expected to consider the impact of varied applications that will intensify data requirements, add reconciliations (including across measures and legal/reporting entity versus line of business basis) and increase reporting production resources.

Trading book versus banking book

Trading book versus banking book boundary distinctions can be significant, particularly with respect to structured products, repurchase transactions, and off-balance sheet activities. Active dialogue among supervisors, implementing institutions and interested constituencies around accounting definitions, cross-industry practices and form versus substance considerations will help define what is subject to A-IRB and the market risk measures. Tangential to these considerations is the measurement of counterparty credit risk, which so far US supervisors and subject institutions have identified as an opportunity for refinement, but may be subject to prioritization and the evolution of the Framework.

Disclosure requirements

These are being addressed by supervisors, implementing institutions and other key constituents. Defining information that satisfies the disclosure principles of the Third Pillar, public filing disclosure requirements and auditing standards represent a key dynamic, particularly in the post Sarbanes-Oxley environment. Considerations include what constitutes proprietary information, the level of detail regarding governance, methodological design, parameters, inputs and derived factors, nature and effectiveness of key controls associated with the derivation, and presentation of the measures and process.

Competitiveness

Competitiveness in the context of Framework implementation can be dimensioned as: inter-jurisdictional, inter-industry and domestic intra-industry. National treatment differences in calibration and scoping of particular products and disclosures are being tracked and addressed by international supervisors via the AIG and related home/host dialogue; inter-industry (investment banking and insurance).

The most significant US development regarding inter-industry/market convergence is the adoption in 2004 of an alternative net capital requirements for broker-dealers that are part of consolidated supervised entities subject to oversight by the Securities and Exchange Commission. These requirements include comprehensive oversight, risk measurement and reporting regime for large internationally active US-based investment companies that have been designed to follow the Framework principles.

Finally, as noted above, the Agencies expect to revise current risk-based capital rules for non-Framework banks coincident with the effective adoption of the Framework. The revisions would directionally harmonize the two measurement systems, which could result in reductions or increases in certain risk-based capital charges associated with certain exposures and activities, such as mortgages and other collateralized obligations, investment securities, and securitizations.

Qualification of approaches

U.S. banking agencies indicate that the proposed rule implementing the Framework will require a formal “notification” process that anticipates an 18-month horizon, which would allow for a one-year parallel run. Institutions that intend to apply the IRB and AMA methodologies at the earliest possible date

(i.e., beginning in 2008) will have had to have fully implemented the necessary systems, with all remedial actions identified by supervisory staff, for use throughout 2007. The Agencies:

- anticipate proposing that (a) no specific approval will be required to initiate parallel runs; and the (b) parallel runs would be confidential and reported on a quarterly basis to the primary Federal regulator; and,
- expect that “systems underlying the advanced approaches would be operating on a stable basis, with inputs derived from reliable and well-established data sets”.

Affirmative qualification during the parallel run period would be necessary in order to use the IRB and AMA results for regulatory risk-based capital purposes on a going-forward basis. The Agencies recognize that, “the Framework-based capital rule is still in development and that the initial qualification process for individual institutions may take more than a year.” Institutions expect to maintain the existing (Basel I) risk-based capital measurement process for several years after completion of the parallel runs, for example until at least 2009, under the earliest timeframe.

Conclusion

Supervisors, subject institutions and interested constituencies expect that as Framework implementation progresses there will be continued enhancement of risk measurement, management, monitoring, reporting and oversight activities. Once implemented, the Framework will help refine the capital estimation and allocation processes that facilitate prudential supervision of an increasingly integrated global banking system.

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Refinement of BHC regulatory capital components—Trust Preferred and other hybrid capital

Effective April 11, 2005, the Federal Reserve Board (“FRB”) adopted a final rule amending its risk-based capital standards for bank holding companies (“BHC”), which continues Tier 1 (core) capital treatment for qualifying trust preferred securities (TPS), subject to stricter quantitative limits. To facilitate application of these limits, certain Tier 1 capital components have been defined as “restricted core capital elements” which include: cumulative perpetual preferred stock, trust preferred securities, and minority interests in the equity accounts of certain consolidated subsidiaries, including REIT preferred. The rule also clarifies and codifies qualifying criteria and supervisory guidance regarding TPS and other restricted core capital elements. Among the key aspects addressed are the following.

Qualifying restricted core capital elements, in aggregate, are limited to:

- 15% of Tier 1 capital elements, less goodwill (adjusted for any associated tax liability) for internationally active BHCs, and
 - defined as BHCs with consolidated assets greater than \$250 billion or on-balance-sheet foreign exposure greater than \$10 billion based respectively on the most recent year-end FR-Y9C and Country Exposure Report (FFIEC 009),
 - Qualifying mandatory convertible preferred securities are excluded from the 15% sublimit, and together with other restricted core capital elements may count up to 25% of Tier 1
- 25% of Tier 1 capital elements, less goodwill, for all other BHCs.
- Excess amounts generally may be included in Tier 2 capital, of which some elements would be further limited with subordinated debt and limited-life preferred stock to 50% of Tier 1 capital. Institutions will be able to order Tier 2 capital elements (i.e., counting non-limited elements first) to reduce crowding out that this limitation might otherwise impose.
- A five-year transition period applies ending March 31, 2009, during which these limits are generally treated as targets with required supervisory consultation and plan to reduce reliance for institutions with amounts in excess of the respective limits.

Grandfathered Tier 1 treatment will apply to certain TPS issued prior to April 15, 2005, of which proceeds were invested in subordinated debt that may not satisfy certain required characteristics.

Qualifying TPS will move from Tier 1 to Tier 2 capital status during the remaining five years to maturity associated with the underlying debt obligation, during which a cumulative straight-line exclusion would apply, consistent with the treatment of limited life instruments.

The requirement for trust preferred securities to include a call option has been eliminated

Standards for the junior subordinated debt underlying trust preferred securities eligible for tier 1 capital treatment have been clarified (e.g., deferral notice, seniority, acceleration, voting rights)

Regulatory financial reporting is reaffirmed to generally conform with GAAP, and that regulatory capital composition and computations may necessarily differ from GAAP.

The rule stipulates that BHC issuance and significant redemptions before maturity of regulatory capital qualifying TPS, and similar instruments, would generally require prior consultation with the relevant Federal Reserve Bank; and reaffirms that the FRB can grant or disqualify favorable capital treatment of such instruments on a case by case basis. For the final text see: <http://www.federalreserve.gov/boarddocs/press/bcreg/2005/20050301/attachment.pdf>.

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