

Basel II and its Likely Impact on Community Banks in the US
Update: OCC and FDIC Approve Final Rule Implementing Advanced Approaches of Basel II

In early November, both the OCC and FDIC issued press releases announcing their approval of a final rule implementing advanced approaches of the Basel II capital accord. This announcement was widely anticipated and paves the way for completion of a proposed rule for the standardized approach under Basel II. Smaller, “non-core” banks in the U.S., will have the option of applying the standardized approach instead of the more complex advanced approach when calculating minimum capital requirements under the Basel II framework. The proposed standardized option will be finalized before actual, initial implementation of the advanced approaches, still set to begin in 2008.

While non-core banks will not be required to use advanced approaches when calculating their regulatory capital under Basel II, it is instructive to briefly examine key components of the advanced approach for a better understanding of how the Basel II framework differs from the existing Basel I capital rules (referred to as “general risk-based rules” in the final rule).

The Basel II Accord stipulates a three pillar framework incorporating credit, market and operational risk for the determination of minimum required capital. Pillar 1 presents approaches for calculating minimum capital requirements. While the final rule retains the minimum tier 1 risk-based capital (RBC) ratio of 4 percent and total risk-based capital of 8 percent, stated methodologies for calculating risk-weighted assets (RWA) differ substantially between the final rule and the existing (general) risk-based capital rules. Advanced capital approaches under Basel II involve an internal ratings-based (IRB) approach for credit risk. Specifically, banks applying the final rule under the IRB approach will use “internal risk measurement systems” for calculating the inputs required to determine RWA. The final rule specifies several categories of RWA, including general credit risk exposures (wholesale and retail), securitization exposures, and equity exposures. Under advanced approach, banks will utilize an “IRB risk-based capital formula” to determine the RBC requirement for each designated exposure. Also, the final rule presents an advanced measurement approach (AMA) for operational risk, incorporating a bank’s own internal estimates of operational risk exposure to determine RBC requirements for operational risk.

Pillar 2 defines the roles of regulatory review including capital adequacy assessments, whereas Pillar 3 establishes public disclosure requirements regarding capital adequacy. Banks using the advanced approaches as presented in the final rule remain subject to the tier 1 leverage ratio requirement, as well as the prompt corrective action (PCA) thresholds and the market risk rule.

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Banker's Economic & Investment ALERT

Volume 16, Number 1, December 2007

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Overall, both the advanced and standardized approaches under the New Capital Accord aim to make the calculation of regulatory capital more sensitive to risk. Issuance of the proposed rule providing smaller, non-core banks with the option of employing the standardized approach under the Basel II framework is expected before year-end.

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