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## **The Current State of the Basel II Process in the United States**

On July 20, 2007, the four primary federal banking regulators, the Federal Reserve, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Deposit Insurance Corporation, issued a joint press release announcing their agreement regarding implementation of the Basel II Capital Accord in the United States. The announcement was significant for reaffirming the agencies' shared "commitment to strive to achieve consensus throughout implementation." For community banks in particular, the July 20<sup>th</sup> press release was meaningful for stating that non-core, or opt-in, banks now have the option of adopting a standardized approach for establishing minimum capital requirements under the Basel II Accord. The earlier proposed Basel IA option has been abandoned. Core banks under Basel II are subject still to the more complicated advanced approach for calculating their minimum capital requirements. The agencies also indicated that the proposed standardized option will be finalized before the initial implementation of the advanced approaches of Basel II, still set to begin in 2008.

Basel II originated from the work of the Basel Committee on Banking Supervision (BCBS) first begun in 1999 to improve upon the then recently adopted Basel I capital framework (Basel I was approved in 1988 and fully implemented in the US in 1992).<sup>1</sup> Basel I, the existing regulatory capital framework, was created to make the determination of regulatory capital more risk sensitive. However, its relatively simple risk-weighting approach, combined with its sole focus on credit risk (ignoring operational risk and market risk in the banking book) and limited recognition of now familiar credit risk mitigation techniques (including collateral, guarantees, and credit derivatives) raised questions as to the adequacy of the resulting regulatory capital allocations, especially for the largest, and most internationally active banks. Concerns involving so-called "capital arbitrage" surfaced whereby banks applying the Basel I framework can increase their exposure to risk without simultaneously increasing their capital requirements. By including differences in credit quality among assets in the same broadly-defined risk category, Basel II, as we shall see, makes it more difficult to increase exposure to riskier assets without also increasing required regulatory capital.

Basel II distinguishes between core and non-core banks. Core banks required to adopt (the advanced approaches of) Basel II are at least \$250 billion in assets, or have at least \$10 billion in on-balance sheet foreign exposure. According to a recently completed report by the US Government Accountability Office, based upon December 2005 regulatory filings, 11 institutions representing 42% of US banking industry assets will be required to comply with Basel II, including (in order of asset size) Bank of America, JP Morgan Chase, Citibank, Wachovia, Wells Fargo, Washington Mutual, HSBC, State Street, Bank of New York, Northern Trust, and Deutsche Bank.<sup>2</sup> The remaining 58% of US banking industry assets, some 8,732 banks, many of them comprising the entirety of

the community banking sector, would have the option of generating more risk sensitive capital allocations by applying the standardized approach under Basel II.

While the four regulatory agencies have yet to issue a final rule for the standardized option under the US version of Basel II, we can review the standardized option as presented in the International Accord for a likely indication of what the US rule would entail.

In June of 2004, BCBS issued the final revised framework for Basel II, also known as the International Accord, which included stipulation of a standardized approach for calculating regulatory capital. This new regulatory capital framework aimed to improve risk management practices and allow capital allocation to be more risk sensitive.

Organized around the following three pillars, the new Accord incorporates operational and market risk as well as credit risk in the determination of minimum required capital:

- Pillar 1 – Stipulates the approaches for calculating minimum capital requirements;
- Pillar 2 – Defines the roles of regulatory review including capital adequacy assessments;
- Pillar 3 – Establishes public disclosure requirements regarding capital adequacy.

International banks following the new Accord using either the advanced or standardized approaches may experience a decline in their regulatory capital requirements as capital allocations are more aligned with risk. (The likelihood that such differences in capital allocations may create competitive disadvantages among banks operating under the US version of the Basel II Accord will be explored in a future article in this series.)

A key aspect of the standardized approach as adopted under the International Accord is the manner in which measured credit risk is supported by so-called external credit assessments (ECA) or external credit ratings as provided by Standard & Poors for example. Risk weights for banking book exposures by borrower type are based upon ECAs as assigned and mapped by the regulatory agencies. The International Accord features the following 6 credit grades:

- AAA to AA-
- A+ to A-
- BBB+ to BBB-
- BB+ to B-
- Below B-
- Unrated

For example, risk weights for “claims on sovereigns,” (i.e., US Treasuries) in the International Accord are mapped as follows:

Credit Assessments	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated
Risk Weights	0%	20%	50%	100%	150%	100%

Alternatively, risk weights for corporates reflect the higher risk levels associated with this borrower type:

Credit Assessments	AAA to AA-	A+ to A-	BBB+ to BB-	Below BB-	Unrated
Risk Weights	20%	50%	100%	150%	100%

By incorporating external credit ratings in the weighting of credit risk by borrow type, the standardized approach effectively expands the risk-weighting categories from the Basel I framework and permits a more risk-sensitive method for determining minimum required capital. Instead of the standard 100% risk weight for corporate exposures under Basel I, banks using the standardized option can assign risk weights based upon third party credit assessments.

US regulatory agencies are expected to issue their proposed rule regarding the standardized approach under Basel II soon. Implementation of the Basel II advanced approaches in the US is scheduled still to begin in 2008, pending release of the final rule.

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<sup>1</sup> BCBS, *International Convergence of Capital Measurement and Capital Standards, A Revised Framework, Comprehensive Version*, June 2006

<sup>2</sup> GAO, *Risk-Based Capital: Bank Regulators Need to Improve Transparency and Overcome Impediments to Finalizing the Proposed Basel II Framework*, February 2007