

**Regulatory Agencies Issue a Joint Notice of Proposed Rulemaking for the Standardized Framework Under Basel II
Part II**

On July 29, 2008, the four primary banking regulators (OCC, Federal Reserve, FDIC, and OTS) published jointly the proposed final rule for the Standardized Framework risk-based capital and capital adequacy guidelines in the Federal Register.¹ We follow up on the second part of this continuing series introducing key aspects of this new risk-based capital (RBC) framework. The Standardized Framework under Basel II could impact significantly the manner in which community banks measure and manage their RBC capital requirements, offering a viable, more risk-sensitive approach beyond the present General Risk Based Rules of Basel I.

In our last article, we began reviewing key components of the Standardized Framework, including applicability issues, merger and acquisition provisions, definitions of qualifying capital, calculation of risk weighted assets, and risk weight categories by exposure for asset types of particular concern to community banks. In the current article we will review provisions for credit risk mitigation (CRM) involving guarantees and collateralized transactions, the Basic Indicator Approach (BIA) for measuring operational risk, and disclosure requirements of the proposed final rule.

Credit Risk Mitigation

Guarantees – To mitigate credit risk, banks are allowed to substitute the risk weight of an eligible guarantor for the risk weight associated with an underlying credit exposure. The Standardized Framework permits a wider range of guarantors and “protection providers” than the general risk based rules (Basel I). Generally, eligible guarantors of interest to the community banking sector include a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation (Farmer Mac), a depository bank, a credit union, a bank holding company, or a savings and loan holding company. In addition, specific language was included in the final rule qualifying “any other entity – other than a special purpose entity (SPE) – that has issued and outstanding an unsecured debt security without credit enhancement that has a long-term applicable external rating,” in other words, corporate or private sector entities with outstanding, unsecured obligations that have been rated by a nationally recognized statistical rating organization (NRSRO). The proposed final rule defines guarantee as a “financial guarantee, letter of credit, insurance, or other similar financial instrument (other than credit derivative) that allows one party (beneficiary) to transfer the credit risk of one or more specific exposures to another party.”

Collateralized Transactions – Again, the Standardized Framework expands the range of eligible financial collateral as compared to the existing, general risk based rules. Specifically, the new framework permits such collateral as long- and short-dated debt instruments with “applicable external ratings” of at least BB- (long-term) or A-3 (short-term), publicly traded equity securities, eligible money market mutual fund shares, and conforming residential mortgages, in addition to collateral permitted under the existing Basel I framework. The new framework also allows three different approaches for applying the benefits of eligible financial collateral: the simple approach, the haircut approach, and the simple VaR (value-at-risk) approach. Community banks are likely to rely upon the simple approach for qualifying collateral, unless they employ collateralized OTC derivative contracts, repo-style transactions, or margin loans, in which case they will have to utilize some combination of either the collateral haircut or simple VaR approaches. Under the simple approach, a bank would risk-weight the collateralized portion of the exposure with the risk weight assigned to the collateral, with the remaining uncollateralized portion of the exposure being subject to the risk weight assigned to the exposure itself.

Operational Risk

A key difference between the Standardized and general risk based capital framework is the inclusion of operational risk as requirement for calculating risk based capital. The proposed final rule defines operational risk as the “risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events (including legal risk but excluding strategic or reputational risk).” To estimate the risk-based capital requirement associated with operational risk, banks electing to apply the Standardized Framework must use the basic indicator approach (BIA). Advanced measurement approaches (AMA), involving the use of “internal risk quantification systems,” are provided by Basel II, and regulators are soliciting input as to whether the AMA should be included in the final rule for the Standardized Framework. The BIA involves the bank averaging the previous three years’ “positive gross income” multiplied by 15 percent to calculate the capital requirement associated with operational risk. Total risk-weighted assets (RWA) for operational risk are estimated by multiplying the resulting capital charge by 12.5. A bank can only count years with positive gross income (PGI) and must exclude years where such income was negative or zero. Essentially, PGI serves as a proxy for a bank’s exposure to operational risk as defined by the final rule. As per the BIA, the capital requirement associated with operational risk is “set at the beginning of the calendar year for the subsequent calendar year.”

Disclosure Requirements

Increased disclosures, both qualitative and quantitative, under the third pillar of the Basel II Accord are aimed at empowering market participants to better assess the risk profiles, risk-based capital levels, and capital adequacy of regulated financial institutions. The Standardized Framework in its present form would require certain mandatory quarterly

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disclosures on the part of the “top-tier legal entity at the consolidated level” (i.e., bank holding company or depository institution level). Additional disclosures beyond existing requirements reflect sharpened regulatory concern regarding the risk profiles of banking institutions and include:

- the aggregate amount by which actual regulatory capital is less than the minimum regulatory capital requirement;
- risk-weighted assets for expanded (credit risk) exposure classes, market risk and operational risk;
- general disclosures for credit risk including definitions of past due and impaired, descriptions of approaches followed for allowances, discussion of the bank's credit risk management policy, geographic distribution of exposures, and industry or counterparty type distribution of exposures;
- credit risk mitigation disclosures including policies and processes for collateral valuation and management, a description of the main types of collateral taken by the bank, the main types of guarantors and their creditworthiness, and information about market or credit risk concentrations within the mitigation taken;
- general disclosures relating to operational risk, including the use of insurance for the purpose of mitigating operational risk;
- general disclosures relating to interest rate risk for non-trading activities.

Federal banking regulators are accepting comments on the Standardized Framework proposed final rule through October 27, 2008.

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¹ Risk Based Capital Guidelines; Capital Adequacy Guidelines: Standardized Framework; Proposed Rule, As published in the *Federal Register*, July 29, 2008. <http://frwebgate6.access.gpo.gov/cgi-bin/waisgate.cgi?WAISdocID=096230116255+2+0+0&WAIAction=retrieve>