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ITEM 4 OF THE AGENDA: IMPLEMENTATION OF THE BASEL II AND CAPITAL REQUIREMENTS DIRECTIVE

In late 2004 and early 2005 the US agencies conducted a Quantitative Impact Study (QIS4) on firms intending to move to Basel II in the US. The results of that study which became available in mid-2005 raised concerns about the potential changes in capital levels in the US following full implementation of Basel II.

As a result, on 30 September the regulatory agencies in the US announced a new timetable for the adoption of Basel II in reaction to the results of QIS4. The Notice of Proposed Rulemaking (NPR) on Basel II will now be released in the first or second quarter of 2006. It is widely expected that this timetable will slip partly due to pressure from Congress.

- The NPR will include more prudential safeguards to ensure that an appropriate level of capital will remain in the system.
- Banks will not be approved to begin their parallel run until 1 January 2008 and then only on a case by case basis.
- Subsequent to beginning the parallel run there will be a three year transitional period with conservative floors in place. The agencies have not yet clarified the basis for the calculation of these floors but they are intended to be "simpler and more conservative" than those set out in Basel II. The following is a comparison of the timetables and floors for both Basel and the US:

Year	Transitional Arrangements
2006	Parallel Run (Basel – FIRB and AIRB)
2007	Parallel Run (Basel – AIRB), 95% Floor (Basel – FIRB)
2008	Parallel Run (US), 90% Floor (Basel)
2009	95% Floor (US), 80% Floor (Basel)
2010	90% Floor, No Floor (Basel)
2011	85% Floor, No Floor (Basel)
2012	No Floors (TBD case by case in US)

- Termination of the floors will be decided on an institution by institution basis in 2011.
- **It is envisaged that the transitional period will be used to identify necessary changes to Basel II in the US.** These changes, which will have to be addressed in the Basel Committee, could result in significant competitive issues on a global basis.
- **Both the Prompt Corrective Action Requirements and the Leverage Ratio will remain in place to supplement the Basel II requirements. Annex 1 sets out the Prompt Corrective Action and Leverage Ratio rules.**

ANPR on Basel 1A

On October 20 the agencies issued a joint release detailing the proposed modifications (**Basel 1A**) to Basel 1 intended to address the competitive implications of a small number of complex national banks moving to Basel II. The changes will apply to banks, bank holding companies and savings banks on a **compulsory basis**. The proposals are intended to:

- modernize the risk-based capital rules to ensure that the framework remains a relevant and reliable measure of the risks present in the banking system,
- minimize potentially material differences in capital requirements that may arise between banks that adopt Basel II and those banks that remain under the existing rules,
- maintain an operationally feasible capital framework that is relatively simple to implement for banking organizations subject to the existing capital rules, and
- use currently available data to implement required changes with the intent of minimizing the burden associated with these modifications.

The following is a broad outline of the changes which are proposed:

- increase the number of risk-weight categories (5 more than Basel 1 and 2 more than B2 STA)
- permit greater use of external ratings for externally-rated exposures (stricter assignment rules than B2 STA)
- expand the types of guarantees and collateral that may be recognized (similar but simpler than B2 STA – substitution of the security issues or guarantor risk weight for the debtor's one for the collateralized portion)

- modify the risk weights associated with residential mortgages and other retail and commercial exposures (similar to B2 STA)
- change the credit conversion factors for certain types of commitments (10% instead of 0% for maturity below 1 year. It is 20% for B2 STA)
- assign a risk-based capital charge to securitizations with early amortization provisions
- assign a higher risk weight to loans that are 90 days or more past due or in nonaccrual status and to certain commercial real estate exposures (B2 STA rw is 150% or 100% according to reserve charge)
- The credit risk charges are deemed to cover both operational risk and banking book interest rate risk.

Testimony of US regulators in Senate Hearing, 10 November 2005

On 10 November the agencies (OCC, Federal Reserve, FDIC and OTS) were called before the Senate Committee on Banking, Housing and Urban Affairs to set out their proposals both on the timetable for Basel II and for the modifications to Basel I. The following is a brief summary of what was said in the Congressional Hearing.

Why go forward with Basel II?

- According to the OCC “The misspecification of risk under Basel I creates inappropriate incentives and arbitrage opportunities that undermine supervisory objectives.”
- Aside from global competitiveness there is a need for global banks to be able to interact meaningfully with a range of supervisors and for the supervisors to be able to work efficiently together.
- Interaction between the trading book and banking book – Basel I is too balance sheet focussed. Banks are now able to use complex instruments to take on risk exposures to support their business strategies and therefore, remove balance sheet risk where the regulatory capital is too high. Smaller organisations are not involved in this kind of activity.

QIS4

- QIS4 was not a final analysis but was based on a crude approximation of Basel II. The banks’ inputs into QIS4 were fall short of the necessary reliability because the models are not yet complete, are at widely different stages of development and there is a lack of definitive rules.
- QIS4 did raise concerns about cyclicalities as the results are clearly indicative of the prevailing economic cycle.
- Capital requirements for mortgages were 90% of current capital held and there was a 60% increase for credit cards. These results are not acceptable and do not reflect the real risks in the system.

- The agencies have agreed to move forward but to put substantial prudential safeguards in place.
- Further study of the QIS4 results will not alleviate the problems. It is essential to see the live systems in operation to identify what needs to change. Therefore the agencies have proposed a meaningful transitional period with conservative floors.
- Any necessary modifications will be made before the end of the transition period.

Prompt Corrective Action requirements and the Leverage Ratio

- Prompt Corrective Action and the Leverage ratio – US institutions have thrived while these provisions have been in place and have remained well-capitalised. PCA requirements will play a crucial role in the floors:
 - 2009 – Basel II – 95% floor – Total risk-based capital ratio of 10% under non-Basel II rules but with a 5% reduction in risk weighted assets.
 - The 10% rule will also have to be met under the Basel II results.
 - Similar dual requirements will apply to the 6% well-capitalised threshold for the Tier I risk-based capital ratio. PCA thresholds for the leverage ratio will remain in place as they currently stand.
- According to the FDIC, moderate capital reductions under Basel II will only be available to banks where they exceed the leverage ratio. The leverage ratio is necessary because:
 - Interest rate risk, liquidity risk and the potential for large accounting adjustments are not specifically addressed in Basel II.
 - The Basel II models are determined subjectively.
 - For operational risk it is not possible to predict events which have never taken place.
 - The low levels of capital allowed under Basel II would erode the safety nets.
 - If the leverage ratio was removed, using QIS4 data the majority of banks would be under-capitalised, significantly under-capitalised or critically under-capitalised.

Concerns for FBE

- ***Changes during the transition period could lead to substantial competitive issues on a global basis. They will raise technical problems for banks operating across jurisdictions.***

- ***Allocation of AMA capital for operational risk – it is technically impossible to build stand-alone systems that are operable due to lack of data and cost. European banks should be able to allocate AMA capital to US subsidiaries which could then be multiplied by a scaling factor to compensate for the diversification effects.***
- ***There is a need for quicker treatment of validation issues for the non-mandatory banks in the US. There is concern that they will not be validated in time to go live because of the focus on the mandatory banks. This could exacerbate the effects of the gap year. There is also concern that the US agencies will be stricter on EU banks because of a perceived competitive advantage.***
- ***European banks need European regulators to agree to flexibility in the interpretation of the CRD allowing US subsidiaries to stay on Basel I during the gap year. It is in the interests of the US agencies to also promote that solution so that they won't have Basel 2 banks operating in the US before the US banks have changed over. This would have political implications.***
- ***There is confusion over whether the new floors will be based on Basel II or Basel IA data. It is also not entirely clear how will they interact with the leverage ration and PCA provisions.***

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