CFO	CFO Action Item

U.S. Risk-Based Capital Rules

Cite

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Advance Notice of Proposed Rulemaking (ANPR)

Risk-Based Capital Standards

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Overview

All of the U.S. banking agencies have released a conceptual proposal on how they would implement the major overhaul of international risk-based capital rules proposed by the Basel Committee. The advance notice of proposed rulemaking (ANPR) would, as indicated, bring only the largest and most internationally-active of U.S. institutions under the new capital, supervisory and disclosure standards, although all other institutions could volunteer for them. The U.S. plans also to impose only the most sophisticated of the Basel II proposals – the advanced internal ratings-based (A-IRB) approach for credit risk and the advanced measurement approach (AMA) for operational risk. However, even in doing so, the U.S. plans to continue the leverage capital requirement and the prompt corrective action sanctions – unique to this country – that may make it very difficult for covered institutions to achieve the capital savings proposed for low-risk loans (principally retail ones and mortgages).

Absent the "topping off" forced by the leverage and total risk-based capital (RBC) standards, capital for low-risk loans would drop dramatically under the A-IRB, although the new operational risk capital charge would offset much of this drop even for institutions principally focused in such activities. For specialized banks, the operational risk charge could be a significant new capital requirement, especially given the need for such institutions to be very well capitalized under the ongoing U.S. total standards. In general, assets structured in securitizations will have a higher capital assessment than comparable assets held in portfolio, a requirement with significant capital market implications and potential costs for credit-card and mortgage institutions now focused principally on securitization. Equity holdings would generally bear higher RBC, a possible cost to banks focused on private equity and merchant banking. Credit risk mitigation would now be recognized for all assets, permitting sharp reductions in RBC when obtained. The U.S. ANPR in general does not discuss the Basel Pillar 2 supervisory standards, but it does include specific, new disclosure requirements (Pillar 3) that would result in significant new public disclosures that would generally fall under new securities law requirements related to certification (although not necessarily to external audit).

Impact

Financial Market Implications

Like Basel's third consultative paper (CP3), the U.S. rules will have a profound market impact.[1] Depending on how the rules are implemented, large banks under them could see dramatic drops in RBC related to key business lines. Even if these are offset by overall total capital standards (discussed below), the business-line benefits of the Basel revisions could result in significant improvements in risk-adjusted return on capital (RAROC) or similar internal profit calculations leading retail banks – especially mortgage ones – to increase their activities in benefited areas.

Conversely, areas where RBC increases – notably high-risk assets and equities, along with certain securitization structures – will see drops in capital-measured profitability. This could lead banks to retrench their subprime, emerging market and related activities in favor of more traditional ones. Overall, financial markets could return to the structure of a decade or so ago, when insured depositories focused on prime market segments and non-banks provided corporate and retail services to others.

[1] See Client Report CAPITAL81, *Financial Services Management,* May 6, 2003.

Banks could again also focus on portfolio operations – not securitization ones – significantly altering the composition of assets available to investors.

The "topping off" impact of the operational risk-based capital charge, as well as the U.S. leverage and prompt corrective action ones, is discussed in more detail below. Absent them, the ANPR, like CP3, would result in big drops in RBC for low-risk books. This achieves the Basel goal of limiting regulatory arbitrage. However, the U.S. regulators' desire that total industry capital and that for individual institutions remain relatively unchanged could adversely affect this goal. For example, a bank would be deemed "well-capitalized" in the U.S. if it held 10% in RBC even if its Basel numbers warranted far more RBC to achieve above-minimum results; conversely, a bank with a low-risk book would be considered under-capitalized under U.S. rules if its RBC dropped below 8%, even if the Basel-derived RBC number was far lower.

The new standards – especially the advanced ones applicable in the U.S. – demand much from banks in terms of internal models and risk management, as well as significant board and senior management involvement in setting the regulatory capital standards. The credit risk ones must drive not only internal controls and RBC, but also pricing and other key business decisions. Thus, a significant reorganization of all Basel-covered banks will likely ensue.

Competitive Impact

The overall market implications briefly discussed above will be differentiated in the U.S. because of the proposal to "bifurcate" application of the new RBC rules. Under the ANPR, only the very largest banks would have to comply with the new rules, but all others could volunteer for them if all of the eligibility criteria are met. Initially, smaller banks and savings associations did not want to be under the Basel rules because of their complexity and cost (worsened now due to the U.S. decision to impose only the advanced options). However, the sharp drops in RBC for certain assets could put institutions outside of Basel II (those under the "general" capital standards in the U.S. dictated by Basel I) at a significant competitive disadvantage. This could, in turn, result in consolidation within the industry in areas where the new RBC standards would dramatically drop regulatory capital. Conversely, institutions focusing on lines of business with high capital requirements might reduce assets or otherwise restructure to avoid application of Basel II.

The Federal Reserve has strongly contested the potential competitive impact of the new rules, arguing that smaller banks have always held higher capital than big ones and thus could successfully compete even if big bank numbers drop dramatically. The OCC has just as vigorously argued the other side, and an extensive series of questions on it are posed. The ANPR states that a "fundamentally different approach" to RBC will be proposed should the answers on competitiveness warrant. This could include not only changes to Basel II, but also to the Basel I rules now in effect.

The U.S. proposes to depart from the European Union not only in limiting the size of banks covered by the new rules, but also by applying them only to insured depositories and their parent organizations. The regulators do have discretion as to which banks to cover and which portions of Basel II to impose, but they lack statutory power to bring under the rules financial services firms that operate outside the financial holding company (FHC) structure. As a result, banks – especially specialized ones – that compete against non-banking institutions in the U.S. could find themselves at a significant capital disadvantage, possibly resulting in industry consolidation or even charter change. Again, this is an issue on which extensive public comment is sought.

Bottom-Line Impact

As noted, the U.S. is unique among Basel signatories because of its leverage (i.e., minimum capital to total assets) requirement and prompt corrective action (PCA) requirements. The latter provide benefits for well-capitalized banks (now determined at a 10% RBC ratio and 5% minimum one) and then impose penalties of increasing severity if a bank's capital ratios fall. The ANPR states that regulators expect total industry RBC levels to remain unchanged in the aggregate, but also that individual institutions could see their capital rise or fall. The proposal, however, also states that the U.S. plans to leave the leverage requirement in place, noting that this will become the "most binding constraint." The PCA standards would also remain in force.

In addition to differing on the possible competitive impact of Basel II, U.S. agencies also disagree on whether to maintain the total capital numbers. The FDIC and OTS are concerned that big drops in RBC could undermine banking system safety and soundness, while the Fed and OCC argue that the purpose of Basel II – ending regulatory arbitrage – will be seriously undermined if total RBC does not in fact reward or punish an individual bank's actual risk.

Should the leverage and total RBC standards remain in force, U.S. banks that would otherwise receive major benefits from Basel II capital changes would need to "top off" their capital to ensure compliance with the overall leverage and PCA standards. This could place U.S. banks at an ongoing disadvantage to EU or other nations' banks, where the total benefit (or cost) would be realized at each covered institution. It could also encourage banks to offset their low-risk books of business with selected high-risk ones to ensure that the total capital numbers work even as the profit benefits of the RBC changes for specific lines of business are realized.

Implementation Cost

The advanced approaches rely on a range of very sophisticated models and risk management standards, as well as significantly increased board and senior management involvement. As a result, implementation costs are expected to be high, with recent studies indicating that the big U.S. banks that must adopt the Basel advanced standards will have to invest $100 million or more. The regulators have expected that the costs would be offset by reduced RBC for lower-risk institutions, but the additional U.S. standards and the operational risk one (see below) will reduce and, in some cases, eliminate these savings.

The ANPR, like CP3, also delays any meaningful Basel II benefit over Basel I for at least two years, with the ANPR indicating that U.S. banks will need regulator approval to go fully to Basel II after two years even if they had previously been approved to use the A-IRB and AMA. This could raise still more doubts about the ultimate cost-benefit results of Basel II as proposed in the U.S.

Operational Risk-Based Capital

The ANPR contains the Basel II proposal for a new operational risk-based capital (ORBC) charge, although only the advanced measurement approach would be allowed. ORBC is among the most contentious aspects of Basel II and, thus, of the ANPR, despite the U.S. effort to counter acknowledged flaws with the simpler aspects of ORBC by imposing only the most sophisticated option. As noted, the proposal could have an adverse impact on specialized banks, particularly those in the U.S. that compete against non-bank asset managers and payments service providers. It could also dramatically reduce the benefits large diversified institutions expect to receive on the credit risk side.

Many questions remain about whether the proposed charge, even in the advanced approach, accurately reflects operational risk because of difficulties defining and measuring it, as well as the benefits received from operational risk (OR) mitigation not reflected in the ANPR. As a result, comment is sought on whether the ORBC charge should be eliminated from the U.S. rules in favor of a supervisory (Pillar 2) approach and, if so, how that approach should work. Were the U.S. to eliminate the ORBC charge, the divergences between the U.S. and EU rules would grow, possibly resulting in separate RBC standards rather than the common one at which Basel II is aimed.

International Implications

As noted, only the U.S. is proposing to mandate use of the most sophisticated sections of Basel II. These are the most complex and costly, although U.S. regulators believe that the simpler options result in too many problems for use here. Foreign banks doing business in the U.S. will, however, be able to use these simpler approaches at home and the cost of developing the advanced ones solely for the U.S. operations may be prohibitive. The ANPR states that only foreign bank U.S. subsidiaries that trigger the size criteria here would need to use the advanced approaches, permitting subsidiaries of very large organizations to operate in this market under Basel I. Questions on this issue are raised and ongoing negotiations are under way to resolve this "home / host" concern.

As noted, the ANPR proposes to tighten the already controversial CP3 limits on benefits for banks using the advanced approaches. Foreign banks, however, will be allowed at the outset of Basel II to use the standardized approach to credit risk and the simpler ones for operational risk, and also to benefit in full at the outset from any capital savings that result. For retail focused banks these savings could be considerable. This would allow them to increase their overall profitability, as well as to push more aggressively into the U.S.

Supervisory Standards

As noted, CP3 includes extensive Pillar 2, supervisory standards. The ANPR does not, however, include any comparable requirements, based on the agencies' view that U.S. standards already comply with the Pillar 2 requirements. Comment is solicited, however, on whether additional operational risk standards are required, either as the noted alternative to the ORBC requirement or as a supplement to it.

U.S. standards, especially the PCA ones, are generally stricter than those proposed under Basel's Pillar 2. As a result, additional competitive issues could arise for covered U.S. banks.

What's Next

The ANPR was published in the *Federal Register* on August 4 following its release on July 11. Comments are due by November 3, 2003. The agencies will then determine whether changes should be sought in the Basel Accord. Should they find Basel II as it heads towards finalization acceptable based on the ANPR comments, the agencies will then begin formal U.S. rulemaking, with a proposal likely in the first quarter of 2004 and a final rule by year-end. The U.S. agencies now plan to have Basel rules in place by January 1, 2007 (the Basel schedule), but the ANPR notes that this could change if comments or data warrant delay.

As noted, supervisory guidances were also released for corporate credit risk and operational risk. Comments on these are due on the schedule noted above. The agencies will also shortly issue guidance for comment on retail credit exposures, equity exposures and securitization.

The agencies also are concerned that the quantitative data on which both CP3 and the ANPR are based are faulty and incomplete. They thus intend to do at least one more formal quantitative study of the specific U.S. rule, as well as expand ongoing economic impact surveys.

The ANPR includes a detailed discussion of specific provisions of U.S. law that govern adoption of rules found to have significant economic impact or an adverse effect on small businesses. The competitive and macroeconomic issues discussed above will have a major impact on findings germane to these economic and related consequences and, should the Basel rules be found to have an economic impact of $100 million or more or meet other statutory criteria, the Office of Management and Budget and other U.S. agencies will become involved in the regulatory process. Thus, even if all of the banking agencies resolve the many controversies left unresolved in the ANPR, the rules could be blocked because of larger Administration concerns.

Congress could also get more involved in the Basel rulemaking. On July 16, the House Financial Services Committee's Financial Institutions Subcommittee voted 42-0 for H.R. 2043, legislation that would mandate regulatory unanimity in Basel decision-making.[2] The Senate Banking Committee held a June 18 hearing on Basel, although no companion legislation is pending.

[2] See Client Report CAPITAL88, *Financial Services Management,* July 16, 2003.

Analysis

I. General Framework

A. Coverage

1. Eligibility

As noted, the regulators are proposing to apply the advanced approaches only to "core" banks – that is, those with $250 billion or more in assets or total on-balance sheet foreign exposure of $10 billion or more. "Opt-in" banks could elect Basel II as long as they meet all of the eligibility criteria discussed below. "General" banks would remain under Basel I and the applicable U.S. implementing rules. As noted, these could change during the Basel implementation process to address competitiveness or other problems. The term "banks" is used throughout, but savings associations are apparently covered due to OTS participation in this rulemaking. Once an institution is deemed a "core" bank (based on the criteria above and passing the various qualifying standards), it would have to stay "core" even if it no longer met the eligibility standards. Institutions that met the size criteria by virtue of merger would be expected to comply with the advanced standards.

2. Holding Company

The U.S. currently imposes Basel I on holding companies (although the rules elsewhere are not imposed on parent organizations). Basel II now proposes parent coverage, and the U.S. would follow suit by continuing to consolidate capital at the parent level. Insured depositories of smaller size within organizations that hit the "core" criteria or that opt in would all have to use the advanced methods, but comment on this is sought. Subsidiaries consolidated for GAAP purposes would have to be consolidated for regulatory capital, but insurance underwriting subsidiaries would generally be deducted in line with CP3. The Federal Reserve is, however, considering a range of options to minimize the cost of such deduction, and comment on this is sought.

As noted, U.S. law does not permit imposition of bank capital standards on non-bank or non-financial holding company parents. Thus, the ANPR would generally not apply to organizations outside the financial holding company structure that own banks unless the insured depository subsidiary was large enough to trigger the "core" definition. Even then (and none of the banks now owned by non-banks fit this criterion), the

ANPR's capital standards would apply only to the banking organization, not to the parent and other affiliates.

3. Foreign Banks in the U.S.

Banks and thrifts in the U.S. owned by foreign institutions would have to use the advanced approaches if the size of their U.S. operations so warrant. Otherwise, they could opt in to the advanced approach or remain under Basel I. Parent organizations abroad, however, would not be required to use the advanced approaches to continue their U.S. activities. Comment on this – which could raise serious problems for foreign institutions – is sought.

B. Definition of Capital and Certain Assets

The definition of regulatory capital would remain unchanged for all banks.

Assets not deemed to be credit exposures – e.g., premises, mortgage servicing rights, – would be subject to the existing general RBC standards and risk-weighted at 100%.

C. Coordination With Current U.S. Rules

The agencies would maintain their current power to raise capital above minimums for all banks if specific risk factors so warrant. The current leverage standards would not change, as would the "prompt corrective action" (PCA) rules that impose sanctions when insured depositories fall from well-capitalized to adequate capitalization and then into under-capitalized categories specified in law.

D. Implementation

Banks that either must or wish to use the advanced approaches need to determine their implementation plans well in advance and through ongoing consultation with their supervisors. Core banks are expected to do so as quickly as possible to ensure they come under Basel II by the final U.S. deadlines. Core banks that fail to qualify by the deadline could be subject to enforcement action. Implementation plans must be approved by the board of directors and be subject to formal regulatory approval (although it is not clear if this would be made public or if the institution would need to announce this on its own).

Inter-agency validation standards to define eligibility for the advanced approaches will be prepared to promote transparency and consistency.

E. Transition

Core and opt-in banks would be expected to run the advanced approaches and Basel I standards in parallel for a year before switching to the new Basel rules. Prior approval to use the advanced approaches is necessary before the parallel run, meaning that banks would have to be approved by December 31, 2005 assuming the current schedule holds.

After approval, risk-weighted assets under the advanced approaches cannot result in final weights less than 90% of Basel I totals in the first year or 80% of Basel I totals in the second year. This is a different approach than CP3, which runs these floors according to regulatory capital, not risk-weighted assets, but the U.S. regulators expect Basel to be revised to this approach when issued in final form.

Final calculation of capital under Basel II after the second year without regard to limits would be permitted only if regulators are confident in the bank's modeling and internal management standards. Any increases in regulatory capital under Basel II, however, would be effective immediately. Banks would need to disclose both the Basel I and Basel II calculations during this period.

Comment on this transition structure is sought.

II. Credit Risk

For a general review of the Basel II framework for credit risk, please see prior FedFin reports.[3] The analysis below focuses solely on specific U.S. concerns and does not assess or explain the underlying Basel standards or terms. However, the agencies are seeking comment on features of CP3 contained in the ANPR.

A. Conceptual Framework

Like CP3, the ANPR assesses RBC for both expected loss (EL) and unexpected loss (UL). Many banks have protested coverage of EL, arguing that this is appropriately addressed through pricing and reserves, with regulators having the power to mandate higher reserves or more regulatory capital if they differ with an institution's EL policy. However, the U.S. rule cites the problems of comparable accounting treatment across all of the nations participating in Basel and the fact that reserves count towards Tier 2 capital as the reason for continuing this approach in the U.S. rules. A change in the reliance on capital for EL would, the agencies

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[3] See Client Report CAPITAL81, *Financial Services Management*, May 6, 2003, CAPITAL83, *Financial Services Management*, May 19, 2003, and CAPITAL 84, *Financial Services Management*, May 22, 2003.

say, require a review of GAAP, current capital definitions and reserve requirements, as well as a major rewrite of Basel II. No specific comment is solicited on this issue, although the agencies note that it is a contentious one.

CP3 and the ANPR do not vary capital according to overall asset correlations – that is, concentration risk. The ANPR indicates that the portfolios of large banks are generally diverse enough to make an additional capital charge for concentration undesirable. However, there is potential risk due to a bank's focus on specific lines of business or geographic areas. Comment on this is sought.

In addition, general comment is solicited on the overall A-IRB approach, with particular attention to the use of external ratings.

B. Default

CP3 permits national regulators flexibility on their definition of "default." The U.S. regulators are proposing to consider that a default has occurred when one or both of the following happens: the borrower is considered unlikely to repay in full without such actions as collateral reorganization and/or the borrower is more than 90 days past due on interest or principal. Comment on this is sought.

The U.S. is proposing a significant departure from Basel II with regard to the treatment of charged-off portions of outstanding loans. CP3 would permit the charge-off to offset any capital on the remaining balance, but the U.S. regulators think this is not prudent. The U.S. standards would reflect the charge-off only to the degree it affected loss and other assumptions.

C. Wholesale Loans

As noted, the U.S. regulators separately issued guidance on the corporate A-IRB, and questions on many aspects of it are sought. In general, large corporate loan RBC would drop, with the ANPR indicating that current data suggest a 20% reduction for the twenty largest U.S. banks.

The ANPR indicates that the wholesale categories would generally remain unchanged. This leaves open the question of how government-sponsored enterprises (GSEs) will be treated. Now, GSEs are granted the same favorable treatment as banks. CP3 indicates that GSEs that are corporate in structure and compete against private firms should generally hold corporate risk weightings – a change from the current U.S. standards not discussed in the ANPR.

Like Basel, the ANPR proposes a drop in capital for wholesale obligations to smaller companies, with the U.S. rule basing the test on sales (not assets). An approximately 39% reduction in capital for small- and medium-sized firms would result from the proposed approach, although many questions are asked with regard to it.

The treatment of commercial real estate (CRE) has been one of the more contentious U.S. implementation issues. The ANPR proposes a more liberal approach than first outlined, with certain construction loans granted less onerous treatment. The U.S. will expect foreign banks doing business in the U.S. to count CRE loans on their books in accordance with the U.S. standards; U.S. banks will be expected to do the same abroad. A range of issues is posed for comment, including whether a simpler approach with a single CRE risk weight is appropriate.

D. Retail Exposures

The regulators are proposing significant flexibility for use of internal models; indeed, they solicit comment on whether they have erred too much in this direction. The standards include a general 3% floor on probability of default (PD) calculations and a 10% floor on loss given default (LGD) for mortgages. These floors will be reconsidered after two years. Although five years of data will be required to use the A-IRB for retail assets, shorter periods will be accepted if the bank persuades its regulator that this represents a full economic cycle.

Here, the definition of default is significantly different than the one proposed above for wholesale loans. Mortgages would have to be charged off after 180 days; other retail assets would have to be charged off after 120 days. Prior to these deadlines, a retail loan would be considered in default if: significant decline in credit quality has occurred, the loan is restructured or forbearance has been provided, or the borrower is in bankruptcy. However, default on one loan would not require the bank to treat all other obligations of the borrower as if in default.

In general, undrawn lines could be treated by incorporating them into the exposure at default (EAD) calculations or by considering potential LGD from both drawn and undrawn balances. Capital must be held regardless of whether the bank plans to sell the undrawn commitment due to the potential risk that it might not be able to do so, but comment on this is requested.

In addition to recognition of future margin income (discussed below), the agencies are considering recognition of general loan loss reserves to reduce RBC for all retail assets. Now, reserves above the 1.25% counted toward Tier 2 capital must be deducted from risk-weighted assets. The agencies are proposing instead that loan loss reserves be allowed to offset the EL portion of the capital requirement in certain circumstances. Doing so would improve the capital reductions noted below and offset some of the increase. Comment is sought on this, as well as on whether specific loan loss reserve should be recognized in any way as an offset to RBC.

1. Residential Mortgages

The U.S. rule would define these loans as those (without any size limit) secured by all loans (including revolving ones) secured by liens on 1-4 family homes. This differs from current RBC standards that differentiate first-liens from home-equity lending. In general, banks should manage these loans as parts of pools, with any not conforming to this requirement treated as corporate exposure. U.S. banks would experience a drop in mortgage RBC of about 56%. Given this sharp drop, an array of questions about the impact of the proposal is presented, with particular focus on whether a housing bubble or other high-risk factors would result.

The U.S. is proposing unique recognition of private mortgage insurance (PMI). Comment is sought on this preferential treatment for PMI, with particular attention to its competitive implications for other credit risk mitigation providers.

2. Revolving Credit

This category is defined to include assets such as credit-card loans and related lines and lines of credit related to checking accounts. Very large credit-card obligations would be considered “other assets” (see below). Here, some recognition of future margin income (FMI) would be allowed to offset capital for EL. This could dramatically drop the amount of relied RBC, and comment on FMI recognition is sought. If they decide to allow use of FMI, regulators will issue additional guidance. Without the proposed recognition of FMI, capital on credit-card portfolios would increase 16%.

3. Other Retail

These assets would include small- and medium-sized (SME) exposures not considered corporate (see above) and all other loans to individuals (regardless of amount) managed as part of a pool, although a $1 million individual exposure limit is proposed for comment. Such loans include auto loans, student loans and a wide array of other retail products. A 25% drop in RBC is expected.

Comment is sought on whether the proposed treatment is inappropriate for specific retail lines.

E. Purchased Receivables

The U.S. is proposing to differ from CP3 here with regard to the recognition of loan purchase discounts and similar strategies. As with charge-offs, CP3 permits these to eliminate RBC if the amount of the charge-off is greater than the initial LGD. The U.S. would require RBC calculation as if the exposure in a purchased receivable were a direct loan, regardless of the face value of the instrument. A variation on this treatment may be allowed for pools of purchased receivables.

Comment on the treatment is solicited, and the agencies will issue guidance on this asset category as part of the final rulemaking.

F. Credit Risk Mitigation (CRM)

Like CP3, the U.S. rules would permit recognition of CRM based on an array of operational and counterparty quality considerations. Repos can be recognized as CRM if various conditions are met. When the bank indemnifies the customer against default by the party borrowing the securities, the indemnification agreement should be treated the same as if the bank had incurred the risk of the principal in the transaction. A detailed value-at-risk (VAR) model for use in securities lending is proposed.

Other than PMI (see above), the rule would not differentiate among guarantee and credit derivative structures. However, the ANPR notes that these vary widely with quite different CRM and measurement implications. Comment is sought on whether the CRM treatment should be differentiated by the type of guarantor and, if so, how. Comment is also sought on whether “double default” protection should be recognized. Doing so would permit far greater recognition of CRM and, thus, reduced RBC.

With regard to credit derivatives, CP3 would allow recognition if the bank has complete control over restructuring. The U.S. agencies believe this could create problems in the underlying obligation, and comment is sought on it and an alternative that would discount the notional amount of a credit derivative that does not include restructuring. The agencies are not comfortable with the CP3 approach to hair-cuts for derivative maturity mis-matches, believing them too low, and comment on this is also sought. Additional counterparty risk charges are also proposed for comment.

G. Equities

Models-driven approaches to equity holdings would be required, with various quantitative and qualitative factors determining eligibility for this approach. The agencies indicate that a minimum 300% risk weight would apply to all publicly-traded equities and a minimum 400% weighting would apply to other equity holdings, suggesting that a bank might be allowed to use the A-IRB for credit risk even as it moved more slowly to the models approach for equity holdings. A-IRB banks where the equity holdings are not material (10% of RBC unless holdings are in less than ten equities) could hold equities at a 100% weighting. When models are used (and considerable discretion to internal ones is proposed), risk weightings for publicly-traded equity would have to equal at least 200% and those for others would have to be at least 300%.

Holdings in Federal Home Loan Bank equities would be weighted at 20% and those in the Federal Reserve at 0%. Comment is sought on exemptive treatment for other equity holdings related to the government. Further, exemptions for SBIC investments would be provided (with a 100% weighting). A complete exemption (with no limitation) is proposed for community development corporation equity holdings, and comment is sought on whether other "legislative program" investments should be similarly treated.

III. Securitization

A. Asset-Backed Securities

This section of the rule remains extremely complex, although some U.S. simplifications are proposed for comment. The agencies note that the forthcoming supervisory guidance on securitizations will likely be very similar to CP3, retaining the proposed higher RBC requirement for securitizations than for comparably-rated corporate bonds. The U.S. regulatory goal is to ensure that RBC after securitization is not greater than if the assets were held, but high capital requirements could in fact result from many of the proposed changes. However, the proposal would reverse current requirements governing credit-enhancing residual exposures (now a 100% RBC charge). Consideration is being given to retaining the current dollar-for-dollar requirement on residuals.

When models are not used, the proposal would permit reliance on external ratings. Here, positions rated below investment grade or those without ratings would have to be deducted in full. Comment on this is sought.

B. Liquidity Facilities

As with CP3, the ANPR treats liquidity facilities as securitization positions. A simplified, "look-through" approach may be used for a limited time if approved by the primary supervisor. Comment on this temporary option is solicited.

C. Early Amortization

The ANPR details the A-IRB treatment for these features, including a more favorable one for "controlled" early amortization triggers that would not include the punitive requirements in CP3 for these structures. Under certain circumstances, these features would carry RBC as if the assets were not securitized. Comment is requested on this.

D. Market Risk

As noted, the market risk rules would largely remain unchanged. It is unclear, however, how FDIC- and OTS-supervised "core" or "opt-in" banks would comply, as these agencies now have no market risk rules.

Current rules generally cover all trading positions under GAAP. Basel II, however, would bring additional positions into the market risk book, and the U.S. agencies solicit comment on this point.

IV. Operational Risk

As noted, U.S. banking organizations would have to hold RBC for operational risk. The ANPR indicates that this is now done through a "buffer" in the current RBC and leverage rules and states that this implicit charge will be eliminated with the explicit ORBC one. However, the rules elsewhere indicate that the current leverage and PCA standards will continue to apply after Basel II is implemented in the U.S. Although the proposal includes the new explicit ORBC charge, comment is sought on whether alternatives to it are preferable.

A. AMA

The AMA in the U.S. notice is comparable in most respects to that in CP3. However, as noted, very detailed implementation guidance was issued in conjunction with the ANPR and extensive comment on the overall approach is solicited. However, the U.S. approach differs in some significant respects from CP3, and could do so even more if issues on which comment is sought are incorporated into the U.S. rules. These include:

- divergence from the Basel definition of operational risk to include a capital charge for indirect losses, such as opportunity cost;
- recognition of reserves or "budgeting" (i.e., future margin income);
- treatment of risk correlation; and

- recognition of insurance and other risk mitigants.

B. AMA Models

The agencies intend to permit considerable flexibility to institutions in developing their AMAs but, at the same time, they want to be able to compare those used by different banking organizations to common supervisory standards. Comment is sought on whether the balance has been struck between flexibility and comparability. The regulators are considering issuance of specific standards for operational risk above and apart from the Basel rules, and comment on whether this is needed are also sought.

To use the AMA, banks would have to have five years of qualifying data. However, CP3 details seven specific OR types. The U.S. regulators are not proposing that banks manage OR according to these categories, but data would have to be mapped according to them.

V. Eligibility Standards for Use of Advanced Models

A. Credit Risk

To rely on internal credit models, banks would have to:

- subject internal ratings to independent control unit evaluation; and
- use these ratings as an "integral part" of their overall management, as detailed in the ANPR. Board review of the A-IRB standards would be required.

As noted, guidance on all of these standards has been or will be proposed, and comment on these criteria is solicited.

B. Operational Risk

To use the AMA, a bank would have to:

- have an independent OR function that meets detailed criteria, including board and senior management supervision. Comment on the required structure is solicited;
- ensure that its own models capture internal and external losses and incorporate specified features (e.g., scenario analysis). Policies could not, however, rely solely on OR quantification, and an assessment of qualitative factors (e.g., internal controls) would also be necessary;
- ensure that AMA quantification has incentives for improved OR management;
- record and report OR in compliance with a detailed schedule;

- meet or exceed minimum OR supervisory standards; and
- test OR data in accordance with detailed standards.

Significantly, the OR qualifications do not require reliance on the AMA for other management purposes, in contrast to the credit risk standards.

VI. Disclosures

A. General Standards

Additional disclosure requirements would be applied to all A-IRB and AMA banks, applicable at the parent bank holding company (but not at individual banks). Failure to meet the disclosure standards could disqualify the bank from using the A-IRB and AMA, as well as result in additional penalties. A formal disclosure policy approved by the board would be required. All information mandated under the RBC process would have to be reflected in the parent firm's corporate disclosures, including the attestation of internal controls and external audits, mandated by the Sarbanes-Oxley Act. Unless mandated by other requirements, the new disclosure standards would not have to be audited by an external party.

Numerous new disclosure requirements are already met by U.S. banks in their public financial reports, call reports or other filings. The U.S. agencies are not proposing additional requirements when this occurs, but they would require banks to compile all of the Basel-mandated disclosures in a single place or to cross-reference where they can be found, possibly through a mandatory summary table on the banking organization's website. Disclosures would have to be made at least quarterly (more rapidly than under CP3).

B. Specific Requirements

The ANPR details the various disclosures mandated in CP3, reaffirming the regulators' intention that none of them result in undue disclosure of proprietary data. Key items include:

- how RBC is structured and consolidated within the banking organization, noting how insurance affiliates are treated;
- how credit risk mitigation works, with data showing not just the systems used, but also how they perform by portfolio, PD, LGDs, etc;
- status of supervisory acceptance of A-IRB and AMA use;

- details on performance of securitization and equity models;
- the AMA selected by the bank;
- the ORBC charge before and after use of mitigation; and
- various interest-rate risk factors.

The agencies are asking for comment on all of the proposed disclosures. Should a commenter contend that proposed data are confidential, regulators have strongly suggested that the comment include backup documentation and details. ❑