

U.S. Implementation of the Basel II Accord: Final Regulations

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Introduction

The federal banking agencies have approved the final regulations for implementation of the Basel II Accord in the United States. It replaces the 1988 Basel I Accord, which had become outdated for large, complex banking organizations. Retaining Basel I for these institutions would have widened the gap between their regulatory capital requirements and their actual risk profiles, generating further incentives for regulatory arbitrage to take advantage of that gap. Essentially, the expanded use of securitization and derivatives in secondary markets, along with vastly improved risk management systems, rendered Basel I obsolete for large international financial institutions.

The primary goal of Basel II is to provide more-risk-sensitive capital requirements for the largest, most complex banks and improve risk management practices at those institutions, all while fostering international consistency. The Basel II Accord was implemented in the United States by the Federal Reserve Board, the FDIC, the OCC, and the Office of Thrift Supervision. See Federal Reserve System, 12 CFR Parts 208 and 225 (Regulations H and Y), Docket No. R-1261, at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20071102a1.pdf>.

In contrast to the simple risk-bucketing approach of Basel I, in which exposures to obligors of varying creditworthiness were given the same capital treatment, the new Basel II rules require banks to distinguish among the credit quality of individual borrowers. For example, under Basel I, almost all first-lien residential mortgage exposures were subject to the same risk weight regardless of the borrower's creditworthiness, whereas Basel II provides for a more refined differentiation of low-versus high-credit-quality mortgage borrowers. Likewise, Basel I became inadequate for dealing with capital markets transactions such as highly structured asset-backed securities. Basel II, on the other hand, provides a much more refined approach by requiring banks to hold capital commensurate with the actual risks of such transactions. Recent market events highlighted the importance of a robust and independent assessment of risk on the part of banks.

Further, financial stability is enhanced when banks' regulatory capital measures adequately reflect risk, as well as when banks continually improve their risk management practices. The Basel II regime is far superior to the current Basel I regime in aligning regulatory capital requirements with risk and fostering continual improvements in risk management. Similarly, the Basel II framework establishes a more coherent relationship between regulatory measures of capital adequacy and the day-to-day risk management conducted by banks. The new accord builds on risk management tools, such as credit-risk rating systems, that are already in use at sophisticated financial institutions. As a result, Basel II will be better able than the current system to adapt over time to innovations in banking and financial markets and will reduce incentives for arbitrage that arise from the gap between what the regulators require and what sound economic risk management requires.

In the view of Jean-Pierre Landau, Deputy Governor of the Bank of France, the implementation of Basel II will bring significant improvements in risk management. Had it been in place some years ago, he speculated, current problems may have been avoided. Federal banking officials acknowledge that Basel II is complex. But this simply reflects the complexity of large financial institutions. To be effective, risk management practices have evolved in order to support the increasingly sophisticated services, business practices, and organizational structures of international financial institutions. Thus, financial institutions already employ sophisticated risk management practices and internal economic capital models. The Fed will carefully review these practices and models before granting the required regulatory approval for individual banks to use the advanced approaches of Basel II.

Three pillars of Basel II

Basel II has three mutually reinforcing pillars. The first pillar is the minimum regulatory capital charge. In order to calculate the capital charge under Pillar 1, banks will have to determine the individual charges for credit, market and operational risk. The new accord offers a series of options for calculating credit and operational risk. Pillar 2 covers supervisory review and the obligation to hold sufficient capital vis-à-vis risk profile. The pillar is intended to ensure not only that financial institutions have adequate capital to support all the risks in their business, but also to encourage them to develop and use better risk management techniques in monitoring and managing these risks.

Under Pillar 2, banks must have an internal process, which will be subject to rigorous regulatory review, for ensuring that they are holding enough overall capital to support their entire risk profile. Regulators will take into account, under Pillar 2, a bank's internal capital-adequacy assessment process, known as its ICAAP, and all other relevant information. The banking agencies expect banks to implement and continually update the fundamental elements of a sound ICAAP, that is, identifying and measuring material risks, setting capital-adequacy goals relating to risk, and ensuring the integrity of internal capital-adequacy assessments. A bank is expected to hold adequate capital against all of its material risks, particularly those risks not covered or not adequately quantified in the risk-based capital requirements, such as liquidity risk. In general, a bank's ICAAP should reflect an appropriate level of conservatism to account for uncertainty in risk identification, risk mitigation or control, quantitative processes, and any use of modeling.

Pillar 3 is designed to improve bank disclosures about risk profiles and enhance discussions between bankers and market participants about risk management practices. Pillar 3 recognizes that market discipline has the potential to reinforce capital regulation and other supervisory efforts. Thus, the new accord embodies a wide range of disclosure initiatives designed to make risk and capital positions more transparent. As a financial institution begins to use the more advanced methodologies for market and operational risk, the new accord will require a significant increase in the level of disclosure.

Pillar 3 is a key mechanism for banks to communicate to market participants about their risk profiles and associated levels of capital. Banks must also disclose information about how they measure and manage credit risk, operational risk, equity risk, and interest-rate risk in non-trading activities, as well as the range of risks related to securitizations. For example, a bank has to describe the operation of its credit risk rating system as well as the data used in parameter estimates for credit losses. While some of these disclosure requirements will be new for banks, others are already required by, or consistent with, existing U.S. GAAP or SEC disclosure requirements.

Principles-based

According to Federal Reserve Board Governor Randall Kroszner, Basel II embodies a principles-based approach that is sufficiently clear about the Board's expectations but is not so detailed that regulators become de facto managers of the bank. A principles-based approach means that the Fed must allow bankers the flexibility to satisfy the requirements and permit a reasonable amount of diversity of practices across banking organizations. This flexibility will allow banks to use and easily improve their existing risk measurement and management practices. More to the point, the Fed will actively encourage these improvements. Although the risk management enhancements envisioned under Basel II will require banks to bear the cost of investing in systems and human capital, he noted, the Fed believes that financial institutions would have made these investments anyway as they seek methods to effectively manage their own increasingly complex risks.

“Gold plating”

As U.S. banking regulators finalized their rules for the implementation of the Basel II Accord, Federal Reserve Board Governor Randall Kroszner expressed concern that the gold plating of the accord adopted by the Basel Committee could result in multiple versions of Basel II across countries. In remarks to the New York Bankers Association, he said that Basel II implementation in the United States should proceed in a manner that enhances consistency with implementation in other countries since the accord is intended to be an international framework for globally active banks.

At the same time, the Fed governor emphasized that the Basel II framework needs to accommodate robust U.S. regulatory practices and the unique aspects of domestic financial markets. He also believes that the Fed has a duty to retain only those divergences in which the regulatory benefits outweigh the implementation burden and costs. He pledged that the Fed would be watchful of areas of Basel II that could unfairly tilt either the domestic or international competitive playing field if some banks have higher or lower capital requirements for certain activities or in the aggregate. One particular concern is that inconsistency in Basel II implementation across countries could put international U.S. banks at a disadvantage and create advantages for U.S. investment banks and foreign banks. Achieving broad international consistency will be a challenge, he conceded, but added that this is not a new problem.

The Federal Reserve Board has long worked with its international counterparts to limit the difficulties and burdens that have arisen as foreign banks have entered U.S. markets and as U.S. banks have established operations in other jurisdictions. This productive cooperation continued during the development and implementation of Basel II. The governor is confident that the Fed can effectively manage the issues that arise given its past experience with cross-border supervision.

Scope

Basel II divides the banking industry into three sectors for purposes of application. First, there are the core banks required to adopt the Basel II rules. These are the large or internationally active banks. Second, there are the opt-in banks that voluntarily decide to adopt Basel II. Third, there are the general banks that decide not to adopt Basel II.

Banks not required to adopt Basel II face a choice about whether to opt-in to the new accord. Some of these banks may be sophisticated institutions that exhibit sound risk management but do not quite meet the criteria to be core banks. The banking agencies recognize that such institutions should be afforded an alternative for more-risk-sensitive capital requirements, but one that is not as complex as Basel II. This was the genesis of the Basel 1A proposal.

The banking regulators have dropped the Basel 1A proposal and instead plan to propose a "standardized" approach to Basel II. Specifically, the staffs are currently working on a notice of proposed rulemaking that would implement some of the simpler approaches for both credit risk and operational risk from the Basel II framework. The proposal is being developed as an optional risk-based capital framework for all banking organizations that are not required to adopt the advanced approaches of Basel II. According to Federal Reserve Board Governor Randy Kroszner, the regulators also expect to retain the existing Basel I-based regulatory capital framework for those smaller banks that would prefer to remain under that regime.

The proposal for the standardized approach will take into consideration relevant commentary received in response to the Basel IA and Basel II proposals and should essentially modernize the Basel I-based rules without imposing a substantial implementation burden. Among other things, the proposal is being designed both to provide greater differentiation across corporate exposures based on borrowers' underlying credit quality and to recognize a broader spectrum of credit-risk mitigation techniques.

The agencies are also considering how to implement Pillars 2 and 3 of the Basel II framework in the standardized proposal in a manner that is commensurate with banks' complexity and risk profiles. The goal is to realize the benefits of these two pillars without imposing excessive regulatory burden and without creating competitive advantages or disadvantages for different types of banks.

Implementation Plan

The key instrument in qualifying under Basel II is a bank's written implementation plan. The plan must be approved by a bank's board of directors. It must describe in detail how the bank complies, or intends to comply, with the Basel II. Specifically, the plan must describe how the bank intends to address the gaps it has identified between its existing practices and the qualification requirements set forth in the rules, covering all consolidated subsidiaries. The implementation plan also must include objective, measurable milestones, including delivery dates, and a target date when the bank expects its advanced approaches to be fully operational. The bank must establish and maintain a comprehensive and sound planning and governance process to oversee implementation efforts, and must demonstrate to its regulator that it meets the qualification requirements.

Banks subject to the final rule on a mandatory basis, the core banks, have up to six months to adopt an implementation plan. Of course, banks may always submit their plans earlier.

After a bank has submitted a credible implementation plan to its primary regulator, it must then begin a parallel run lasting at least four consecutive calendar quarters, during which the regulator must determine the bank's compliance with the qualification requirements to be satisfactory. During the parallel run, a bank remains subject to the Basel I risk-based capital rules for all applicable regulatory purposes, but the bank also must calculate its capital ratios using the advanced approaches and report pertinent information to its regulator.

It is only upon notification from its regulator that a bank can move into a series of three transitional periods (each lasting at least one year), during which the cumulative reductions of the bank's risk-based capital requirements are limited. Regulatory approval is needed to move to a subsequent transitional floor-level and then to move from the transitional floors to stand-alone use of the Basel II rules.

Risk Management

Risk management is at the heart of Pillar 2, including the risk of securitization exposure. The banking agencies believe that a bank's risk management processes should reflect the scope and complexity of its business lines, as well as its corporate organizational structure. Each bank's risk profile is unique and should have a tailored risk management approach appropriate for the scale and materiality of the operational risks present in the bank.

Under Basel II, a bank must have operational risk management processes, data and assessment systems in place that meet the qualification requirements in section 22(h) of the final rules. The risk management function must be independent of business line management. The roles and responsibilities of the operational risk management function may vary between banks, but should be clearly documented. The risk management

function should have an organizational stature commensurate with the bank's operational risk profile. At a minimum, the bank's operational risk management function should ensure the development of policies and procedures for the explicit management of operational risk as a distinct risk to the bank's safety and soundness.

Similarly, a bank must also establish and document a process to identify, measure, monitor and control operational risk in bank products, activities, and systems. This process should provide for the consistent and comprehensive collection of the data needed to estimate the bank's exposure to operational risk. It must also capture business environment and internal control factors affecting the bank's operational risk profile. The process must also ensure reporting of operational risk exposures, loss events, and other relevant risk information to business unit management, senior management, and the board of directors, or a designated committee of the board. The final rules define an "operational loss event" as an event that results in loss and is associated with any of the following seven operational loss categories: (1) internal fraud; (2) external fraud; (3) employment practices; (4) products and business practices; (5) damage to physical assets; (6) business disruption and system failures; (7) execution delivery.

Ultimately, a bank's board of directors has accountability for the effectiveness of the bank's risk management systems. However, it is not necessarily the board's responsibility to conduct an evaluation of the effectiveness of a bank's systems. Evaluation may include transaction testing, validation, and audit activities more appropriately the responsibility of senior management. Thus, the final rules require a bank's board of directors to review the effectiveness of, and approve, the bank's advanced systems at least annually.

To support senior management's and the board's oversight responsibilities, a bank must have an effective system of controls and oversight that ensures ongoing compliance with the qualification requirements; maintains the integrity, reliability, and accuracy of the systems; and includes adequate corporate governance. Banks have flexibility to determine how to achieve integrity in their risk management systems. They are, however, expected to follow standard control principles in their systems such as checks and balances, separation of duties, appropriateness of incentives, and data integrity assurance, including that of information purchased from third parties.

Moreover, the oversight process should be sufficiently independent of the systems' development, implementation, and operation to ensure the integrity of the component systems. The objective of risk management system oversight is to ensure that the various systems used in determining risk-based capital requirements are operating as intended. The oversight process should draw conclusions on the soundness of the components of the risk management system, identify errors and flaws, and recommend corrective action as appropriate.

In addition, a bank must validate its advanced systems on an ongoing basis. Validation is the set of activities designed to give the greatest possible assurances of accuracy of the systems. Validation includes three broad components: (i) evaluation of the conceptual soundness of the systems; (ii) ongoing monitoring; and (iii) outcomes analysis that

includes back-testing. Each of these three components of validation must be applied to the bank's risk rating and segmentation systems, risk parameter quantification processes, and internal models that are part of the bank's advanced systems. A sound validation process should take business cycles into account, and any adjustments for stages of the economic cycle should be clearly specified in advance and fully documented as part of the validation policy. Further, senior management should be notified of the validation results and take corrective action where appropriate.

A bank's validation process must be independent of the advanced systems' development, implementation, and operation, or be subject to independent assessment of its effectiveness. A bank should ensure that individuals who perform the review are not biased in their assessment due to their involvement in the development, implementation, or operation of the processes or products. For example, reviews of the internal risk rating and segmentation systems should be performed by individuals who were not part of the development, implementation, or maintenance of those systems. In addition, individuals performing the reviews should possess the requisite technical skills to fulfill their mandate.

Internal audit

A bank must have an internal audit function independent of business-line management that at least annually assesses the effectiveness of the controls supporting the bank's advanced systems. Internal audit should review the validation process, including validation procedures, responsibilities, results, timeliness, and responsiveness to findings. Further, internal audit should evaluate the depth, scope, and quality of the risk management system review process and conduct appropriate testing to ensure that the conclusions of these reviews are well founded. Internal audit must report its findings at least annually to the bank's board of directors, or a board committee.

Stress testing

A bank must periodically stress test its risk management advanced systems. Stress testing analysis is a means of understanding how economic cycles, especially downturns as described by stress scenarios, affect risk-based capital requirements, including migration across rating grades or segments and the credit risk mitigation benefits of double default treatment. Stress testing analysis consists of identifying stress scenarios and then assessing the effects of the scenarios on key performance measures. Under the rules, changes in borrower credit quality will lead to changes in risk-based capital requirements. Because credit quality changes typically reflect changing economic conditions, risk-based capital requirements may also vary with the economic cycle.

During an economic downturn, risk-based capital requirements will increase if wholesale obligors or retail exposures migrate toward lower credit quality rating grades or segments. Federal banking regulators expect banks to manage their capital position so that they remain at least adequately capitalized during all phases of the economic cycle. A bank that credibly estimates regulatory capital levels during a downturn can be more

confident of appropriately managing regulatory capital. Thus, banks should use a range of plausible but severe scenarios and methods when stress testing to manage regulatory capital. Scenarios may be historical, hypothetical, or model-based. Key variables specified in a scenario may include, for example, interest rates, transition matrices, asset values, credit spreads, market liquidity, economic growth rates, inflation rates, exchange rates, or unemployment rates.

A bank may choose to have scenarios apply to an entire portfolio, or it may identify scenarios specific to various sub-portfolios. The severity of the stress scenarios should be consistent with the periodic economic downturns experienced in the bank's market areas. Such scenarios may be less severe than those used for other purposes, such as testing a bank's solvency.

The scope of stress testing analysis should be broad and include all material portfolios. The time horizon of the analysis should be consistent with the specifics of the scenario and should be long enough to measure the material effects of the scenario on key performance measures. For example, if a scenario such as a historical recession has material income and segment or ratings migration effects over two years, the appropriate time horizon is at least two years.

Documentation

A bank must adequately document all material aspects of its advanced systems, including internal risk rating and segmentation systems, risk parameter quantification processes, model design, assumptions, and validation results. The guiding principle governing documentation is that it should support the requirements for the quantification, validation, and control and oversight mechanisms as well as the bank's broader risk management and reporting needs.

Documentation is also critical to the supervisory oversight process. The bank should document the rationale for all material assumptions underpinning its chosen analytical frameworks, including the choice of inputs, distributional assumptions, and weighting of quantitative and qualitative elements. The bank also should document and justify any subsequent changes to these assumptions.

Categorization of Risk Exposures

A bank's risk exposures have been grouped into four major categories: wholesale, retail, equity, and securitization. Given the recent market turmoil involving securitization, this risk category looms large.

Securitization exposure

As noted, Pillar 2 of Basel deals with risk management. An important subset of risk management is managing the risk of securitization exposures, both traditional securitization and synthetic securitization. The current model of securitization has two distinctive features. One is the increasing complexity of customized derivatives, which has made valuation and risk assessment more difficult. The second is the fragility of off-balance sheet structures and vehicles that underpin securitization. Structured investment vehicles are not built to absorb shocks. Their relationships with sponsor banks are sometimes ambiguous, he noted, and there may be a gap between the legal commitments taken by the banks through liquidity support and credit enhancements and the true level of responsibility they felt obliged to take to protect their reputation.

Basel II defines “securitization exposure” as an on-balance sheet or off-balance sheet credit exposure that arises from a traditional or synthetic securitization, including credit enhancing representations and warranties. A “traditional securitization” is a transaction in which:

- Credit risk of underlying exposures is transferred to third parties other than through the use of credit derivatives or guarantees;
- The credit risk associated with the underlying exposures has been separated into at least two tranches reflecting different levels of seniority;
- Performance of the securitization exposures depends upon the performance of the underlying exposures;
- All or substantially all of the underlying exposures are financial exposures, such as loans, credit derivatives, asset-backed securities, or mortgage-backed securities;
- The underlying exposures are not owned by an operating company or a small business investment company; and
- The underlying exposures are not owned by a firm an investment in which qualifies as a community development investment under 12 U.S.C. 24(Eleventh).

A “synthetic securitization” is a transaction in which:

- Credit risk of underlying exposures is transferred to third parties through the use of credit derivatives;
- The credit risk associated with the underlying exposures has been separated into at least two tranches reflecting different levels of seniority;
- Performance of the securitization exposures depends upon the performance of the underlying exposures; and
- All or substantially all of the underlying exposures are financial exposures, such as loans, credit derivatives, asset-backed securities, or mortgage-backed securities.

The final definition of a traditional securitization also provides the primary federal regulator of a bank with discretion to exclude from the definition of traditional securitization investment firms that exercise substantially unfettered control over the size and composition of their assets, liabilities, and off-balance sheet transactions. The agencies will consider a number of factors in the exercise of this discretion, including an assessment of the investment firm's leverage, risk profile, and economic substance. This exclusion is intended to provide discretion to a bank's primary regulator to distinguish structured finance transactions, to which the securitization framework was designed to apply, from more flexible investment firms such as many hedge funds and private equity funds.

Only investment firms that can easily change the size and composition of their capital structure, as well as the size and composition of their assets and off-balance sheet exposures, would be eligible for this exclusion from the definition of traditional securitization under this new provision. The banking agencies do not consider managed collateralized debt obligation vehicles, structured investment vehicles, and similar structures, which allow considerable management discretion regarding asset composition but are subject to substantial restrictions regarding capital structure, to have substantially unfettered control. Thus, such transactions meet the final rule's definition of traditional securitization.

Note that the Basel II rules also include two exclusions to the definition of traditional securitization for small business investment companies and community development investment vehicles. As a result, a bank's equity investments in SBICs and community development equity investments generally are treated as equity exposures under the final rule.

The banking agencies expressed concern that the line between securitization exposures and non-securitization exposures may be difficult to draw in some circumstances. Thus, in addition to giving bank regulators exclusionary discretion, Basel II adds a new component to the definition of traditional securitization that specifically permits a primary federal regulator to scope certain transactions into the securitization framework if justified by the economics of the transaction. Similar to the analysis for excluding an investment firm from treatment as a traditional securitization, the banking agencies will consider the economic substance, leverage, and risk profile of transactions to ensure that the appropriate classification is made. The agencies will consider a number of factors when assessing the economic substance of a transaction including, for example, the amount of equity in the structure, overall leverage (whether on- or off-balance sheet), whether redemption rights attach to the equity investor, and the ability of the junior tranches to absorb losses without interrupting contractual payments to more senior tranches.

The Basel II rules do not define all mortgage-backed pass-through securities guaranteed by Fannie Mae or Freddie Mac to be securitization exposures. As a result, those mortgage-backed securities that involve tranching of credit risk will be securitization

exposures; while those mortgage-backed securities that do not involve tranching of credit risk will not be securitization exposures.

Several commenters asked the bank agencies to clarify whether a special purpose entity that issues multiple classes of securities that have equal priority in the capital structure of the issuer, but different maturities, would be considered a securitization SPE. The agencies do not believe that maturity differentials alone constitute credit risk tranching for purposes of the definitions of traditional securitization and synthetic securitization.

Rejecting the assertion that OTC derivatives with a securitization SPE as the counterparty should be excluded from the definition of securitization exposure, the banking agencies said that the securitization framework is the most appropriate way to assess the counterparty credit risk of such exposures because this risk is a tranching exposure to the credit risk of the underlying financial assets of the securitization SPE. Thus, provided there is a tranching of credit risk, securitization exposures could include, among other things, asset-backed and mortgage-backed securities; loans, lines of credit, liquidity facilities, and financial standby letters of credit; credit derivatives and guarantees. But a typical syndicated credit facility would not be a securitization exposure so long as less than substantially all of the borrower's assets are financial exposures.

The banking agencies believe that a single, unified approach to dealing with the tranching of credit risk is important to create a level playing field across the securitization, credit derivative, and other financial markets. Thus, they decided to maintain the proposed treatment of tranching exposures to a single underlying financial asset in the final rules. Basing applicability of the securitization framework on the presence of some minimum number of underlying exposures would complicate the rule, they reasoned, and would create a divergence from the new accord, without any material improvement in risk sensitivity.

The securitization framework is designed specifically to deal with tranching exposures to credit risk. Moreover, the principal risk-based capital approaches of the securitization framework take into account the effective number of underlying exposures.

Operating companies are not traditional securitizations under Basel II, even if all or substantially all of their assets are financial exposures. Operating companies generally are companies that produce goods or provide services beyond the business of investing, reinvesting, holding, or trading in financial assets. Examples of operating companies are depository institutions, bank holding companies, securities brokers and dealers, insurance companies, and non-bank mortgage lenders. Accordingly, an equity investment in an operating company, such as a bank, generally would be an equity exposure under the final rules; a debt investment in an operating company, such as a bank, generally would be a wholesale exposure.

In contrast to the framework for wholesale and retail exposures, the securitization framework does not permit a bank to rely on its internal assessments of the risk parameters of a securitization exposure. For securitization exposures, which typically are

tranching exposures to a pool of underlying exposures, such assessments would require implicit or explicit estimates of correlations among the losses on the underlying exposures and estimates of the credit risk-transferring consequences of tranching. These correlation and tranching effects are difficult to estimate and validate in an objective manner and on a going forward basis. Instead, the securitization framework relies principally on two sources of information to determine risk-based capital requirements: (i) an assessment of the securitization exposure's credit risk made by a nationally recognized statistical rating organization (NRSRO); or (ii) the risk-based capital requirement for the underlying exposures as if the exposures had not been securitized, along with certain other objective information about the securitization exposure, such as the size and seniority of the exposure.

The securitization framework contains three general approaches for determining the risk-based capital requirement for a securitization exposure: a ratings-based approach, an internal assessment approach, and a supervisory formula approach. Consistent with the new accord, a bank generally must apply the following hierarchy of approaches to determine the risk-based capital requirement for a securitization exposure:

- An exposure qualifies for the ratings-based approach if it has an external rating from an NRSRO or has an inferred rating (that is, the exposure is senior to another securitization exposure in the transaction that has an external rating from an NRSRO). For example, a bank generally must use the this approach to determine the risk-based capital requirement for an asset-backed security that has an applicable external rating of AA+ from an NRSRO and for another tranche of the same securitization that is unrated but senior in all respects to the asset-backed security that was rated. In this example, the senior unrated tranche would be treated as if it were rated AA+.
- If a securitization exposure does not qualify for the risk-based approach, but the exposure is to a credit enhancement or liquidity facility, the bank may apply the internal assessment approach. A bank qualifies to use this approach if it maintains an internal risk rating system for exposures to asset backed commercial paper programs that have been approved by the bank's primary federal regulator.
- The supervisory formula approach is a catch-all approach. In many cases, an originating bank would use the supervisory regulatory approach to determine its risk-based capital requirements for retained securitization exposures.

Wholesale exposure

The rules define a wholesale exposure as a credit exposure to a company, individual, sovereign entity, or other governmental entity (other than a securitization exposure, retail exposure, or equity exposure). The term company is broadly defined to mean a corporation, partnership, limited liability company, depository institution, business trust, SPE, association, or similar organization. Examples of a wholesale exposure include a non-tranched guarantee issued by a bank on behalf of a company and a repo-style transaction entered into by a bank with a company.

Retail exposure

Retail exposures generally include exposures (other than securitization exposures or equity exposures) to an individual and small exposures to businesses that are managed as part of a segment of similar exposures, not on an individual-exposure basis.

Equity exposure

The Basel II rules define an equity exposure to mean a security or instrument (whether voting or non-voting) representing a direct or indirect ownership interest in, and is a residual claim on, the assets and income of a company. It is also a security or instrument that is mandatorily convertible into a security or an option or warrant that is exercisable for a security. Finally, an equity exposure is any other security or instrument (other than a securitization exposure) to the extent the return on the security or instrument is based on the performance of a security.

Disclosure and Transparency

Recognizing the importance of market discipline in encouraging sound risk management practices and fostering financial stability, Pillar 3 of the new accord, requires meaningful disclosure to allow market participants to assess key information about a bank's risk profile and its associated level of capital. With enhanced transparency, investors can better evaluate a bank's capital structure, risk exposures, and capital adequacy.

The banking agencies believe that quarterly public disclosure is important to ensure that the market has access to timely and relevant information. Thus, Basel II mandates quarterly quantitative disclosure within 45 days after calendar quarter-end. Quarterly disclosure is consistent with longstanding U.S. requirements for robust quarterly disclosures in financial statements. Specifically, many of the existing SEC disclosure requirements that a bank may use to help meet its public disclosure requirements are already required on a quarterly basis. Quarterly disclosure is also appropriate considering the potential for rapid changes in risk profiles.

In addition, management may determine in some case that a significant change has occurred, such that the most recent disclosure does not reflect the bank's capital adequacy and risk profile. In those cases, banks should disclose the general nature of these changes and briefly describe how they will likely affect public disclosures going forward. These interim disclosures should be made as soon as practicable after the determination that a significant change has occurred.

The disclosures must be publicly available, such as included on a public website, for each of the latest three years. Management generally has discretion to determine the appropriate medium and location of the disclosures; and has flexibility in formatting the disclosures. The banking agencies did not specify a fixed format for these disclosures. That said, the banking agencies encourage management to provide all of the required

disclosures in one place on the bank's public website. But alternatively, banks may provide the disclosures in more than one place, as some of them may be included in public financial reports, such as in Management's Discussion and Analysis included in SEC filings. Banks using this alternative approach must provide a summary table on their public website specifically indicating where all the disclosures may be found.

Disclosure of tier 1 and total capital ratios must appear in the footnotes to the year-end audited financial statements. Thus, these disclosures must be tested by external auditors as part of the financial statement audit. Disclosures that are not included in the footnotes to the audited financial statements are not subject to external audit reports for financial statements or internal control reports from management and the external auditor.

One or more senior officers of the bank must attest that the disclosures meet the requirements of the final rules. The senior officer may be the chief financial officer, the chief risk officer, an equivalent senior officer, or a combination thereof.

Consistent with providing banks with considerable discretion, bank management determines which disclosures are relevant based on a materiality concept. In addition, bank management has flexibility regarding formatting and the level of granularity of disclosures, provided they meet certain minimum requirements. Thus, the banking agencies believe that banks generally can provide these disclosures without revealing proprietary and confidential information. Only in rare circumstances might disclosure of information required in the final rules compel a bank to reveal confidential and proprietary information. In these unusual situations, the rules requires that, if a bank believes that disclosure of specific commercial or financial information would prejudice seriously the position of the bank by making public information that is either proprietary or confidential in nature, the bank need not disclose those specific items, but must disclose more general information about the subject matter of the requirement, together with the fact that, and the reason why, the specific items of information have not been disclosed. This provision applies only to those disclosures required by Basel II; and not to disclosure requirements imposed by accounting standards or other regulators, such as the SEC.

Disclosure tables

The public disclosure requirements of Basel II are comprised of 11 tables that provide information to market participants on the scope of application, capital, risk exposures, and risk assessment processes. Table 11.1 requires disclosure of the basic context underlying regulatory capital calculations. The bank must describe the level in the organization to which the disclosures apply and outline any differences in consolidation for accounting and regulatory capital purposes, as well as describe any restrictions on the transfer of funds and capital within the organization.

Table 11.2 deals with capital structure. It requires disclosure of various components of regulatory capital available to absorb losses and allow for an evaluation of the quality of the capital available to absorb losses within the bank.

Table 11.3 covers capital adequacy. It requires disclosure of bank assessment of the adequacy of its capital and requires that the bank disclose its minimum capital requirements for significant risk areas and portfolios. Such disclosures provide insight into the overall adequacy of capital based on the risk profile of the organization.

Tables 11.4, 11.5, and 11.7 require disclosure of credit risk in order to provide market participants with insight into different types and concentrations of credit risk to which the bank is exposed and the techniques being used to measure, monitor, and mitigate those risks. These disclosures are intended to enable market participants to assess credit risk exposures without revealing proprietary information. The banking agencies are not prescriptive with regard to what is meant by major types of credit exposure, disclosure by counterparty type, or impaired and past due loans. Bank management has the discretion to determine the most appropriate disclosure for the bank's risk profile consistent with internal practice, GAAP or regulatory reports. For major types of credit exposure, a bank could apply a breakdown similar to that used for accounting purposes, such as loans, off balance sheet commitments, and other non-derivative off-balance sheet exposures, debt securities, and OTC derivatives.

Table 11.6 requires disclosure related to credit exposures from derivatives, including counterparty credit risk from OTC derivatives.

Table 11.8 requires disclosure of the amount of credit risk transferred and retained by the bank through securitization transactions and the types of products securitized. These disclosures will provide users a better understanding of how securitization transactions impact the credit risk of the bank. The banking agencies refused to explicitly acknowledge that they will accept the definitions and interpretations of the components of securitization exposures that a bank uses for financial reporting purposes (FAS 140 reporting disclosures). Instead, they reiterated that banks will generally be able to fulfill some of their disclosure requirements by relying on disclosures made in accordance with accounting standards or SEC mandates. In these situations, however, a bank must explain any material differences between the accounting or other disclosure and the disclosures required under Basel II.

Table 11.9 requires disclosure of operational risk in order to provide insight into what internal and external factors are considered in determining the amount of capital allocated to operational risk.

Table 11.10 requires disclosure enabling market participants to understand the types of equity securities held by the bank and how they are valued. The table also provides information on the capital allocated to different equity products and the amount of unrealized gains and losses.

Finally, Table 11.11 mandates disclosure about the potential risk of loss that may result from changes in interest rates and how the bank measures such risk.

About the Author

James Hamilton is a Principal Analyst at Wolters Kluwer Law & Business, a leading provider of corporate and securities information, and a prolific blogger (Jim Hamilton's World of Securities Regulation at <http://jimhamiltonblog.blogspot.com/>). Hamilton has been tracking, analyzing and explaining securities law and regulation for nearly 30 years as an analyst for CCH. He has written and spoken extensively on federal securities law and has been cited as an authority by a federal court. His analysis of the Sarbanes-Oxley Act, the *Sarbanes-Oxley Manual: A Handbook for the Act and SEC Rules*, is considered a definitive explanation of the Act. His other works include the popular guidebook *Responsibilities of Corporate Officers and Directors under Federal Securities Law*, the *Guide to Internal Controls*, and the monthly newsletter *Hedge Funds and Private Equity: Regulatory and Risk Management Update*. In addition to his many books and articles, Hamilton serves as a leading contributor to the industry-standard publication, the *CCH Federal Securities Law Reporter*. Hamilton received an LL.M. from New York University School of Law.