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Developments of Note

➢ US Banking Agencies Publish Interagency Guidance on Advanced Basel II Qualification Process

The four US banking agencies published an interagency statement (the "Interagency Statement") on the Basel II Advanced Approaches ("Advanced Basel II") qualification process. Advanced Basel II is discussed in detail in the November 6, 2007 and November 27, 2007 issues of the *Alert*. Terms used but not defined in this article have the meanings set forth in those *Alerts*. The Interagency Statement updates the qualification process guidance published in January 2005. The Interagency Statement separates its discussion into four components: implementation plan, parallel run, transitional floor periods, and other matters.

Implementation Plan. The Interagency Statement mandates that each bank that plans or is required to use Advanced Basel II adopt a board-approved implementation plan (the "Implementation Plan"). The Implementation Plan must cover the consolidated bank holding company (or top-tier savings association) as well as each individual depository institution ("DI") within the structure. The Implementation Plan must address all requirements of Section 22 of Advanced Basel II (including its internal capital adequacy assessment process (Pillar 2) and approach to public disclosure (Pillar 3)). The Implementation Plan also must address a self-assessment of where the bank is in meeting the qualification requirements, a gap analysis of what still needs to be done, and a timetable to address areas identified in the gap analysis. While the agencies will permit a wide variety of formats for the Implementation Plan, it must include address (via appendices or individual plans) the specifics of how each DI will comply.

Because the Implementation Plan is the only precondition to entering a parallel run, the agencies have "high expectations" for its overall quality. The Implementation Plan should be provided to the primary point of contact, such as an Examiner-in-Charge, at each bank's primary agency supervisor. As to timing, core banks (as defined in Advanced Basel II) must adopt the Implementation Plan by October 1, 2008 (or, if later, within six months of becoming a core bank). Every bank must submit its Implementation Plan at least 60 days before the start of its parallel run, unless the agency grants a waiver from the prior notice requirement. Core banks generally must provide for a first transitional period by April 1, 2011. The agencies will provide feedback throughout this period, with more robust feedback during the parallel run period.

Parallel Run. As discussed in Advanced Basel II, during the parallel run period a bank adopting Advanced Basel II will remain subject to the current capital rules, but will also report its risk-based capital as calculated according to Advanced Basel II. The Interagency Statement reiterates that a parallel run will be deemed satisfactory, and thus allow a bank to progress to the next phase, if it has at least four consecutive quarters of complying with the Advanced Basel II qualification requirements (*e.g.*, ICAAP, AMA, IRB) to the satisfaction of its primary federal regulator. Indeed, the Interagency Statement provides that a bank "should not consider beginning the parallel run until it expects to be in a position to demonstrate compliance with the qualification requirements detailed in section 22 of [Advanced Basel II] for at least four consecutive quarters."

Transitional Floor Periods. After successful completion of the parallel run, the Interagency Guidance states that the appropriate federal regulator will identify the start date for a bank's first transitional floor period. Each transitional floor period has its own maximum reduction from the current risk based capital rules (*i.e.*, first-5%; second 10%; third-15%), and a bank may not move from one transitional period to the next without four consecutive quarters of compliance and approval of its federal regulator. Moreover, in 2010, the regulators must publish a study that evaluates the implementation of Advanced Basel II, and if any material deficiencies exist must make appropriate adjustments (including, perhaps, by amending Advanced Basel II). The Interagency Statement provides that during this period each covered bank must provide five capital ratios to the regulators (*i.e.*, risk based under the current rules and Advanced Basel II, and the leverage ratio), and the regulators expect constant improvement in systems and processes throughout the transition periods.

Other Matters. The Interagency Statement also addresses a number of items under a category referred to generically as "Other Matters." In this regard, the Interagency Statement highlights that a strong validation process, both as to point-in-time assessments as well as ongoing activities, is critical to a satisfactory Advanced Basel II system. Moreover, the Interagency Statement provides that a bank must notify its regulator if it makes any change that would result in a material change in risk-weighted assets for a type of exposure, or any significant change in modeling assumptions. The Interagency Statement also provides in this section that supervisory exemptions from Advanced Basel II for DI subsidiaries are expected to be "granted on an infrequent basis."

In addition, in the event of a merger or acquisition, the acquirer must (1) submit an Implementation Plan within 90 days of the merger to bring incorporated exposures into Advanced Basel II within 24 months, and either (2) if the target already is using Advanced Basel II, continue to use those systems during the interim period, or (3) if the target is not using Advanced Basel II, continue to use the current capital rules during the interim period. If an acquirer acquires a target during the acquirer's implementation of Advanced Basel II, the acquirer is not required to take any special steps, but rather simply must comply with the process described immediately above (*e.g.*, the 90 day Implementation Plan requirement). Finally, the Interagency Statement notes that there are a number of areas (in addition to those described above) where Advanced Basel II requires prior agency approval, including: (1) the internal models methodology for counterparty credit risk; (2) double default treatment; (3) the Internal Assessment Approach for ABCP securitization exposures; and (4) the Internal Models Approach for equity exposures.

➢ FRB Chairman Bernanke, Secretary of the Treasury Paulson Testify Before House Committee Regarding Oversight of Investment Banks and Revisions to Financial Regulation

Ben S. Bernanke, Chairman of the FRB, and Henry M. Paulson, Secretary of the Treasury, testified on financial regulatory reform before the U.S. House Committee on Financial Services. In general, Chairman Bernanke and Secretary Paulson agreed that (although Congress should not enact a hurried-through response to financial regulatory reform) regulators should be provided with additional regulatory tools to deal with financial crises and stronger oversight over the largest financial institutions.

I. Chairman Bernanke's Recommendations.

(a) Prudential Supervision of Investment Banks. Chairman Bernanke stated that since the near collapse of Bear Stearns in March 2008, the FRB and SEC have worked closely to see that the four largest investment banks "have the financial strength needed to withstand conditions of extraordinary market stress." The FRB and SEC have signed a Memorandum of Understanding to formalize their arrangement (see the July 8, 2008 *Alert*). In the longer term, however, said Chairman Bernanke, legislation may be needed to strengthen prudential supervision of investment banks and other large securities dealers. Chairman Bernanke suggested that Congress consider "requiring consolidated supervision" of investment banks and other large securities dealers and providing regulators with the "authority to set standards for capital, liquidity holdings, and risk management."

(b) Strengthening the Financial Infrastructure. Chairman Bernanke stated that the threat to the financial system posed by the potential collapse of Bear Stearns was exacerbated by weaknesses (i) in the market for over-the-counter derivatives and (ii) in the short-term funding market. Chairman Bernanke recommended that Congress consider granting the FRB explicit authority to oversee and supervise systematically important payment and settlement systems because, at this time, the FRB must rely on a "patch-work" of authorities, derived from its role as a banking regulator, plus moral suasion to oversee payment and settlement systems risk.

(c) Preventing or Mitigating Future Crises. Chairman Bernanke stated that new tools are required to ensure an orderly liquidation of a "systematically important securities firm that is on the verge of bankruptcy…" Moreover, regulators need to have a more formal process for deciding when and how to intervene and use the foregoing regulatory tools. Chairman Bernanke stated that one example for Congress to consider in designing such legislation is the Federal Deposit Insurance Corporation Improvement Act ("FDICIA") process used for dealing with insolvent commercial banks. The FDICIA process requires that the resolution process selected involve the lowest cost to the government (and thereby the U.S. taxpayer) except where using the least-cost solution would entail significant systemic risk.

II. Secretary Paulson's Recommendations

Secretary Paulson, in his remarks, summarized certain of the key elements of the Treasury's Blueprint for a Modernized Financial Regulatory Structure that was issued in March 2008 (see the April 1, 2008 *Alert*). He then noted three near-term steps that he believes would move U.S. financial regulation in the direction of the Treasury's Blueprint for reform:

(a) Give the FRB the clear statutory authority to prevent events that pose unacceptable systemic risk. Specifically, said Secretary Paulson, the FRB needs the authority to access necessary information from complex financial institutions of all types: commercial banks, investment banks, hedge funds and others. Moreover, said Secretary Paulson, the FRB needs the tools to intervene "to mitigate systemic risk in advance of a crisis."

(b) Secretary Paulson stated that for market discipline to be effective, market participants "must not expect" that government support "is readily available." In particular, said Secretary Paulson, financial institutions must be allowed to fail.

(c) Secretary Paulson also asserted that when the government is required to provide financial support, it should be required that the Treasury Department be involved and, to the extent possible, taxpayer costs should be minimized.

III. Subsequent Related Developments

Over the weekend following the delivery of Chairman Bernanke's and Secretary Paulson's remarks, the FRB announced that it would open its discount window to Fannie Mae and Freddie Mac, if needed. Borrowings would be at the primary credit rate and be required to be collateralized by U.S. government and federal agency securities. The Bush Administration also announced that it would amend the legislation it is backing to reform the regulation of government-sponsored enterprises ("GSEs"), including Fannie Mae and Freddie Mac, to give the FRB a consultative role in the setting of capital requirements for GSEs. Furthermore, the OTS closed IndyMac Bank, a $32 billion bank in Pasadena, California and turned IndyMac Bank over to the FDIC as receiver. IndyMac Bank's failure has been attributed primarily to issues in its residential real estate loan portfolio. The FDIC opened the successor bank, IndyMac Federal Bank, FSB on July 14, 2008. The OTS said that IndyMac Bank was the largest OTS-regulated thrift ever to fail and that it was, according to FDIC records, the second largest institution to close in U.S. history.

➢ BIS Publishes Study on Lessons Learned in the Recent Failure of Structured Finance Ratings and Provides Recommendations

The Basel Committee on the Global Financial System (the "Basel Committee") published a study (the "Study") of ratings in structured finance. The Study notes that since the second half of 2007, asset-backed securities ("ABS") have suffered through a period of dramatic repricing due to performance deterioration of subprime mortgages that were packaged into residential mortgage-backed securities ("RMBS"). There has been a simultaneous wide-scale revision in ratings on structured finance ("SF") products backed by RMBS that has revealed weakness in investors' risk management and raised questions about the ability of credit rating agencies ("CRAs") to rate complex SF products. The Study focused on lessons derived from the recently revealed weaknesses in the ratings and provided possible solutions.

The Study states that CRAs' underestimation of the severity of the housing market downturn, reliance on limited historical data and the underestimation of originator risk, combined with a failure to adequately monitor rated SF securities, produced the frequent ratings downgrades that have characterized the SF market in the past year. Drawing on these failures and their results, The Basel Committee sets our four lessons: (1) credit rating information should support, not replace, investor due diligence, particularly when assessing the risk of the underlying collateral; (2) CRAs should enhance the information underlying SF ratings to facilitate comparison of risk with and across different SF products; (3) better information on the CRAs assumptions regarding the key risk factors that influence SF ratings is needed; and (4) CRAs should, when assigning ratings, periodically take into account the system-wide risk implications of rapid growth by similar SF instruments or vehicles.

The Basel Committee also offered ten recommendations to address weaknesses and improve investor confidence in SF product ratings. These recommendations include:

1. Investment fund trustees and managers should review how ratings information on SF products is used in their investment mandates and decisions.

2. Rating reports should be standardized and presented in a way that facilitates comparisons of risk within and across classes of SF products.

3. Rating agencies should provide clearer information on the frequency of rating updates, including the timing of post-issuance reviews.

4. More user-friendly access to CRA models and their documentation should be provided. Rating models made available by CRAs should facilitate stress tests and allow users to alter CRA assumptions on key model parameters.

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5. CRAs should document the sensitivity of SF tranche ratings to changes in their central assumptions regarding default rates, recovery rates and correlations.

6. CRAs should clearly and regularly disclose to investors their economic assumptions underlying the rating of SF products, including how the CRA expects each rated tranche to perform under different economic scenarios.

7. Where only limited historical data on underlying asset pools is available, this should be clearly disclosed as a source of model risk, as should any adjustments made to mitigate this risk.

8. CRAs should monitor more intensively the performance of the various agents involved in the securitization process and assign ratings to mortgage originators' loan approval processes.

9. CRAs should periodically consider the wider systemic implications of rapid growth of similar SF instruments or vehicles, or of new business undertaken by existing SF vehicles, for the continued accuracy of their original ratings criteria.

10. CRAs should consider how to incorporate additional information on the risk properties of SF products into the rating framework.

Other Item of Note

➢ SEC Proposes Amendments to Expand the Scope of Broker-Dealer Registration Exemptions under Rule 15a-6 for Certain Foreign Broker-Dealers

The SEC recently published for public comment a release (the "Proposing Release") setting forth numerous proposed amendments to Rule 15a-6 under the Securities Exchange Act of 1934. The proposed amendments are intended to increase the range of services foreign broker-dealers are allowed to offer in the United States by updating and expanding the scope of certain exemptions from broker-dealer registration contained in Rule 15a-6. Rule 15a-6 is the principal SEC rule under which non- U.S. broker-dealers (including non-U.S. banks) engage in certain securities activities within the U.S or with certain U.S. persons. The comment period for the proposal, which a future *Alert* will discuss in greater detail, runs through September 8, 2008.