

# Financial Services Alert

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## *Developments of Note*

### ➤ **Banking Agencies Publish Final Rulemaking for US Basel II**

The federal banking agencies (the “Agencies”) issued a final rulemaking (“Rule”) on all aspects of the US implementation of Basel II (which currently is anticipated to begin in early 2008). The Rule is a very extensive document. This *Alert* will address the credit components of the Rule. Future *Alerts* will address collateral, equities, securitization, and operational risk rules. A proposed rule was issued for the market risk rules on September 25, 2006 (see the September 26, 2006 *Alert*).

**I. Overview.** Despite some industry calls for more alternatives as in the international Basel II Accord (the “International Accord”), the Rule permits only the Advanced Internal Ratings Based Approach (“A-IRB Approach”) for credit risk, and a coordinate Advanced Measurement Approach (“AMA Approach”) for operational risk (collectively, the “Advanced Approach”). The Advanced Approach would be mandated for the largest US-based international banking institutions (“core banks,” as defined below), and others could opt-in provided that they had the appropriate systems.

All other U.S. banks will continue to use the current ratings based approach, as amended to take into account a proposed standardized approach process (proposed rules are due in the first quarter of 2008). As the Rule highlights, the Advanced Approach principally affects the risk-weight denominator for purposes of calculating Tier 1 and Total capital ratios (the “Risk-Based Capital Ratios”). The Advanced Approach generally does not affect: (1) the calculation of the numerator (*i.e.*, the qualifying capital) of the Risk-Based Capital Ratios (although the A-IRB does not require certain capital deductions, such as of non-financial equity investments); (2) the leverage capital ratio calculation; or (3) the ratios required under the Prompt Corrective Action Rules (each of which would still apply), and, as applicable, the market risk rule.

However, as stated in a release this Summer, the Agencies have agreed not to impose the proposed 10 percent limitation on aggregate reduction in risk-based capital. Instead, the Agencies will issue a series of reports during the transition period (with the 3 year transition period remaining in the Rule) to determine if any material deficiencies in the Advanced Approach exist. More generally, the Agencies sought greater harmony between the Rule and the International Accord.

**II. Applicability and Implementation of the Advanced Approach.** The Agencies continue to treat as a core bank any US depository institution (“DI”) that has either (1) consolidated total assets of \$250 billion or more on year-end regulatory reports, or (2) consolidated total on-balance sheet foreign exposure of \$10 billion or more at the most recent year-end. In addition, a US-chartered bank holding company (“BHC”) is a core bank if the BHC either (i) meets the consolidated asset thresholds described above for banks (excluding from the \$250 billion asset calculation assets of insurance underwriting subsidiaries), or (ii) has a subsidiary bank that is a core or opt-in bank. The Rule states this approach is intended to prevent BHCs from structuring operations for regulatory arbitrage by moving bank assets into non-bank affiliates. The Rule also provides that the OTS does not intend to apply capital requirements to savings and loan holding companies. For foreign banks with US-chartered DIs, the above-standards apply at the US-DI level, and, if applicable, US-BHC level (although the same US BHC capital exemption provided by SR 01-01 would remain available).

Despite industry comment, the Agencies also decided to retain the requirement that any DI (regardless of size or function) that is a subsidiary of a DI or BHC that uses the Advanced Approach must itself use

the Advanced Approach. However, in an effort to mitigate some of the commenters' concerns, the Rule does permit a banking organization to request a regulatory exemption from this requirement for a DI.

Any banking organization seeking to apply the Advanced Approach will have to develop detailed, Board of Director-approved, implementation plans (with core banks adopting a plan within 6 months after it achieves the requisite size), and obtain its primary Agency's approval. For core banks, the implementation plan must include a first transitional floor period start date no later than 36 months after the later of (1) the effective date of the Rule, or (2) the date the institution met a size threshold to be a core bank. A bank also may exclude portfolios or business lines from the A-IRB if it can demonstrate that, in the aggregate, such exposures are not material to the bank. Section 22 of the Rule also details the qualification requirements for banks implementing the Advanced Approval, including process and systems requirements, risk rating and segmentation systems, quantification systems, data management and maintenance, and control and validation mechanisms.

Banks will be required to use in parallel the Advanced Approach and current capital rules for 1 year (starting in 2008, at the earliest) prior to using the Advanced Approach on a stand-alone basis. During the parallel-use period the bank will have to show that it met the A-IRB qualification requirements (but, in response to industry comment, not necessarily *all* of these requirements). Moreover, a banking institution will have minimum capital floors for at least three years (occurring in 2009-2011, at the earliest) after applying the Advanced Approach on a stand-alone basis (95%, 90% and 85%, respectively, of what the risk-weighted assets would be under the current rules). During the transitional periods, a bank's capital for all non-risk based capital purposes (*e.g.*, Reg W) will be calculated using only the Advanced Approach.

**III. The A-IRB Approach.** The A-IRB approach is based on an evaluation of possible losses with respect to credit exposures over a 1 year time horizon, with a confidence level of 99.9%. As in the Notice of Proposed Rulemaking regarding the U.S. implementation of Basel II (the "NPR"), generally banks may focus on unexpected losses, rather than also include expected losses ("EL"). Excluding EL entirely, however, is dependent upon a bank maintaining sufficient eligible credit reserves to offset the EL. If EL is less than such reserves, the difference is deducted equally from Tier 1 and Tier 2 capital; if it exceeds such reserves, the bank may include such difference in Tier 2 capital up to .6 percent of credit risk-weighted assets.

The A-IRB capital formulas basically divide on-and off-balance sheet credit into two categories: wholesale and retail. The other 2 categories of assets covered by the Rule are securitizations and equities, which, as noted above, will be addressed in a future *Alert*. Assets not defined by any asset category generally are assigned risk weights equal to their carrying value for on-balance sheet exposures, or notional amount for off-balance sheet exposures.

*Wholesale Exposures.* Wholesale exposures generally include corporate, sovereign, and interbank exposures, as well as specialized lending exposures (but not securitizations, or certain small-business exposures that qualify for retail exposure treatment). With limited exceptions for exposures to certain speculative development loans called high volatility commercial real estate ("HVCRE") (which receive less favorable capital treatment), the Rule provides the same A-IRB capital formula for all wholesale exposures. In contrast to the International Accord, the Rule does not provide lower risk weights for exposures to small-and medium-sized enterprises ("SME"). The ratings must be updated at least annually.

The first A-IRB input for general wholesale exposures is probability of default ("PD"), which is based on an internal rating the institution assigns to each wholesale obligor (or, in response to industry comment, the obligor's guarantor), with a general minimum PD of 3 basis points (except for certain very high quality exposures, such as sovereigns). With limited exceptions for special circumstances (*e.g.*, DIP financing and income producing property) the Rule requires each obligor (as opposed to each

exposure) to have a single rating for the PD input. The bank must have at least 7 discrete grades for non-defaulted obligors and another one for defaulted obligors.

The second principal input is loss given default (“LGD”), which may not be less than zero and is expressed as an estimate of the bank’s total exposure at default (“EAD”) (taking into account recoveries, guarantees (including possible double default treatment), etc.) reflecting economic downturn conditions. The Rule, like the NPR, does not require banks to determine downturn conditions for a particular category of exposures on less than a national level. A bank generates LGD with its own internal estimates (after regulatory approval). Per industry comment, the Agencies eliminated the supervisory mapping function. In response to industry comments, the Agencies also eliminated the Expected Loss Given Default input from the Rule.

The third principal input is EAD, which generally is the amount legally owed to the bank in the event of default (*i.e.*, the carrying value for balance sheet amounts, plus an estimate of most off-balance sheet amounts, which estimates may reflect reduction in exposures during economic downturn).

The final principal input is the effective maturity (“M”) of the obligation, which generally must be set between 1 and 5 years (with exceptions for repo-style transactions and similar obligations). Having established the exposures subject to the wholesale category and these inputs, the bank: (1) assigns wholesale obligors and exposures to rating grades; (2) assigns risk parameters (*e.g.*, the inputs) to wholesale obligors and exposures; and (3) calculates risk weighted assets for the exposures based on regulatory formulae.

*Retail Exposures.* The retail exposure category encompasses the vast majority of credit exposures to individuals. This category has 3 subcategories: (1) residential mortgages (first or subsequent liens); (2) qualifying revolving exposures (“QREs”, generally credit cards and overdraft lines); and (3) other retail exposures (including auto, student, margin, and consumer installment loans, and some SMEs up to a \$1 million exposure). The principal distinction between the A-IRB treatment of retail and wholesale exposures is that the former are risk-weighted in segments, rather than on an individual basis, and generally no particular number of segments is required. The ratings generally must be updated quarterly.

The credit pools generally must be segregated by their risk drivers, with PD, LGD and EAD (but not maturity) remaining important A-IRB inputs. As to PD, the Rule requires two different approaches (although it provides more flexibility than the NPR) depending upon the materiality of the seasoning effects in the pool. Unlike in the NPR, the Rule permits banks to estimate retail EAD exposures on a segment rather than individual basis.

As with wholesale exposures, there would be a 3 basis point PD minimum, and also a 10% LGD minimum for residential mortgages not federally-guaranteed. The Rule notes that a 1991 federal law mandated a 50 percent risk weight for certain 1-4 family construction and multi-family loans, and a 100 percent risk weight for certain construction loan for which the purchase contract is cancelled. The Rule basically provides an A-IRB alternative for the 50% loans, but maintains the statutory standard for the 100% loans.

*Default.* As the foregoing evidences, the definition of “default” is critical to the inputs of US Basel II. In response to industry comment, the Rule amends the definition to more closely correlate to the Basel Accord. In the case of wholesale exposures, the term “default” generally will include any obligation (1) the bank considers the obligor is unlikely to pay in full, or (2) which is more than 90 days past due. An unlikelihood to pay may be indicated by, for example: (1) placing the exposure on non-accrual status consistent with Call Report instructions, (2) taking a full or partial charge off because of the obligor’s financial condition, or (3) incurring a material credit related loss on sale. Notably, the 5 percent sale on loss provision was eliminated as a trigger mandating default characterization. For retail exposures, the Rule tracks the standards in the FFIEC’s Uniform Retail Credit Classification and Account

Management Policy. Unlike with wholesale classifications, the definition of default for retail purposes is determined on an exposure-by-exposure basis (as opposed to obligor basis, as with wholesale). If a US bank has a non-US subsidiary subject to an IRB approach, with Agency approval the non-US subsidiary may use the definition of default in that jurisdiction.

**IV. Effect of Merger or Acquisitions.** In response to industry comment, the Rule also addresses merger and acquisition transition provisions in greater detail. A bank qualifying to use the A-IRB (and, unlike the NPR, also a bank in the process of qualifying) may use the transition provision (and thus use the general risk-based capital rule or the acquired bank's A-IRB, as appropriate) with respect to the target's exposure for 24 months (and 36 months with Agency approval). To obtain this transition period, the acquirer must submit a plan with its Agency within 90 days (rather than 30 in the NPR) after the consummation of the transaction.

➤ **Related Materials**

["OCC Approves Basel II Capital Rule," Comptroller of the Currency, November 1, 2007](#)

Basel II Preamble (<http://www.occ.gov/ftp/release/2007-123a.pdf>)

Basel II Final Rule (<http://www.occ.gov/ftp/release/2007-123b.pdf>)