

Basel II Final Rule

Introduction

Earlier this month, the federal banking agencies (the “Agencies”) published a final rule implementing the Basel II Accord capital rules for the largest, most internationally active U.S. banking organizations. Basel II is an effort by international banking supervisors to update the original international bank capital accord (Basel I), which has been in effect since 1988. The Basel Committee on Banking Supervision, on which the United States serves as a participating member, developed Basel II. The purpose of Basel II is to improve the consistency of capital regulations internationally, make regulatory capital more risk sensitive and more reflective of risk exposures arising from complex financial instruments that were not contemplated by Basel I, and promote enhanced risk-management practices among large, internationally active banking organizations.

To achieve its goals, the Basel II Accord set forth a “three pillar” framework:

- **Pillar 1:** includes a credit risk component that is measured by either a “Standardized Approach” or an Internal Ratings-Based (“IRB”) approach. There is a separate methodology for assessing the credit risk associated with securitizations. Pillar 1 also includes operational risk and market risk components. There are a number of methodologies for addressing operational risk, including the Advanced Measurement Approach (“AMA”).
- **Pillar 2:** supervisory review of capital adequacy.
- **Pillar 3:** market discipline through enhanced public disclosures.

What Is the Status of Basel II in the United States?

While the final rule represents the culmination of several years of debate about how to apply Basel II to the largest U.S. banks, the overall implementation of Basel II in the United States remains something of a work in progress.

With regard to the final rule, while the Basel II Accord includes several methodologies for determining risk-based capital requirements, the Agencies are adopting only the advanced approaches at this time: the IRB approach for credit risk and the AMA for operational risk. The IRB approach uses risk parameters determined by a bank’s internal systems in the calculation of the bank’s credit risk capital requirements.

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Specifically, the IRB approach requires banks to assign risk parameters to wholesale exposures and retail segments and provides specific risk-based capital formulas that must be used to transform these risk parameters into risk-based capital requirements. The bank's primary federal regulator, as part of its supervisory review, will assess each institution's determinations. The AMA relies on a bank's internal estimates of its operational risks to generate an operational risk capital requirement for the bank.

There are still open issues for U.S. banks subject to the final rule. The final rule does not address market risk, which is the subject of a separate and still-pending rulemaking proceeding.¹ Additionally, the Agencies proposed supervisory guidance in February 2006 that is to be used in conjunction with the final rule. These proposals have not yet been finalized.²

For all other U.S. banks, the Agencies intend to propose a rule in early 2008 that will implement the Standardized Approaches to credit and operational risk. The Agencies had previously proposed a "Basel IA" rule, which has formally been scrapped but still may offer some clues as to the content of the anticipated 2008 proposal.

How Will the Final Rule Affect U.S. Banks?

The final rule adopted by the Agencies is mandatory for "core" banks and permits "opt-in banks" to adopt the advance approaches if they meet the applicable qualification requirements. Core banks are those with consolidated total assets of \$250 billion or more or with consolidated total on-balance-sheet foreign exposure of \$10 billion or more. A depository institution is considered a core bank if it is a subsidiary of another depository institution or bank holding company that uses the advanced approaches. Opt-in banks must satisfy the conditions outlined in Section 22 of the final rule, including having a rigorous process for assessing overall capital adequacy in relation to its risk profile and a comprehensive strategy for maintaining an appropriate level of capital, systems and processes consistent with internal risk management processes and management information reporting systems, and an appropriate infrastructure with risk measurement and management processes that meet the qualification requirements and are appropriate given the bank's size and level of complexity.

It is estimated that there will be approximately 11 core banks that are required to adopt the final rule and possibly an equal number of banks that will opt-in to the advance approaches of the final rule.

¹ See 71 Fed. Reg. 55958 (Sept. 25, 2006).

² See 72 Fed. Reg. 9084 (Feb. 28, 2007).

When Will the Final Rule Take Effect?

The final rule formally takes effect on January 1, 2008, but a core or opt-in bank will not be fully subject to the terms of the rule – or enjoy the full benefits of the rule – until 2012. There is effectively a four-year phase-in process. First, each core and opt-in bank must conduct a “parallel run” of capital requirements for four consecutive quarters. That is, during these quarters, each bank must calculate risk-based capital under both the current requirements and those in the final rule; the current requirements govern during this period. Parallel runs may begin in the first quarter of 2008. Second, if each bank’s primary federal regulator is satisfied with the parallel run, then the bank may rely on the provisions of the final rule to calculate its risk-based capital. For the first three years, however – i.e., 2009-2011 – the bank’s new capital requirements cannot go below 95 percent, 90 percent and 85 percent, respectively, of its capital requirements under the current rules. After these three years, the capital floors are removed. The federal agencies have committed, however, to conduct a study of the effects of the final rule before 2012, which could result in further adjustments to the final rule before that year.

Meanwhile, for non-core and non-opt-in banks, the Agencies have announced that a final rule implementing the Standardized Approach will be in place before 2009.

What Does Not Change With the Final Rule?

It is important to keep in mind that the final rule – as well as other elements of Basel II still to be implemented in the United States – does not change several key aspects of bank capital:

- **Capital components.** The current definitions of Tier 1 and Tier 2 capital are essentially unchanged by the final rule and Basel II. There are a few marginal adjustments relating to the treatment of reserves and deductions for certain equity investments, but the final rule and Basel II should not materially affect the terms of equity securities that U.S. banks may issue.
- **Leverage ratio.** Largely at the insistence of the FDIC, all U.S. banks will remain subject to leverage ratio requirements. Generally, the leverage requirement for banks themselves is 5 percent; for bank holding companies, it is 4 percent.
- **Prompt corrective action.** These requirements also remain unaffected. U.S. banks, regardless of size, will want to remain well-capitalized, with Tier 1 and total risk-based capital ratios of 6 percent and 10 percent, respectively, as well as a leverage ratio of at least 4 percent. Sanctions will continue to kick in if the Tier 1 risk-based ratio drops below 4 percent, the total risk-based ratio below 8 percent, or (in many cases) the leverage ratio below 4 percent.

The final rule and Basel II also do not address with specificity many of the risks, apart from credit risk, that may affect the financial condition of a bank. To take the most recent public example – the turmoil in the credit and secondary markets and the resulting decrease in liquidity – the final rule, had it been in effect, would not have caused U.S. banks to act significantly different than they did in originating, selling, or investing in mortgage loans. Liquidity risk is subsumed in the second pillar of Basel II, which provides regulators broad and unspecified discretion to adjust capital requirements for banks for reasons other than credit risk.

How Will the Final Rule Affect Community Banks?

Opting-in to the final rule will not likely be a viable option to community banks due to the cost, complexity and burdensome eligibility standards. Community banks will have to wait until the Agencies agree upon a final rule that is consistent with the Standardized Approach in the Basel II Accord. Since community banks will continue to be subject to the current risk-based capital rules, and the largest banks in the United States will be subject the advanced approaches to Basel II, the following challenges may arise:

- **Competitive considerations.** As a very general rule, Basel II and the final rule reduce capital requirements for the least risky assets and increase them for the most risky assets. Thus, core and opt-in banks may be able to hold less capital than other banks against certain types of historically low-risk loans, such as prime residential mortgages and accordingly would be able to offer more competitive lending rates than other banks. Community banks would have an advantage in funding commercial loans because Basel II banks would be required to hold more capital for these more risky loans.
- **Cost and complexity.** Implementing the final rule will be very expensive and complex. Although it is difficult if not impossible to quantify, there is something of a scaling issue embedded in Basel II: compliance is to some extent relatively less expensive for the very largest banks than for others. The cost-benefit analysis for opt-in banks is thus a complicated one.
- **Consolidation.** Because the relative expense required to obtain some of the arguably favorable capital features of the final rule, non-core banks may agree to be acquired by core or opt-in banks in order to remain competitive.

The Agencies are aware of these potential challenges. The Standardized Approach will be designed to minimize potentially material differences in capital requirements likely to emerge once the advanced approaches of Basel II are implemented by the largest banks in the United States. Additionally, the Agencies have stated that this new framework is designed to evolve over time and adapt to innovations in banking and the financial markets. Finally, the Agencies have vowed to monitor Basel II during every step of its implementation.

This advisory was written by:

Jeffrey L. Hare
202.239.3902
jeffrey.hare@alston.com

Stephen Racioppi
404.881.7877
stephen.racioppi@alston.com

Randolph A. Moore III
404.881.7794
randy.moore@alston.com

Dwight C. Smith, III
202.756.3325
dwight.smith@alston.com

For additional information or guidance please contact your Alston & Bird attorney or one of the attorneys in the firm's **Financial Services & Products Group**.

ATLANTA

One Atlantic Center
1201 West Peachtree Street
Atlanta, GA 30309-3424
404.881.7000

CHARLOTTE

Bank of America Plaza
101 South Tryon Street
Suite 4000
Charlotte, NC 28280-4000
704.444.1000

DALLAS

2200 Ross Avenue
Suite 4650W
Dallas, TX 75201
214.432.7770

NEW YORK

90 Park Avenue
New York, NY 10016-1387
212.210.9400

RESEARCH TRIANGLE

3201 Beechleaf Court
Suite 600
Raleigh, NC 27604-1062
919.862.2200

WASHINGTON, DC

The Atlantic Building
950 F Street, NW
Washington, DC 20004-1404
202.756.3300

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