Office of Thrift Supervision
Department of the Treasury

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MEMORANDUM FOR: **CHIEF EXECUTIVE OFFICERS**

FROM: James E. Gilleran

SUBJECT: Basel II Capital Accord

I. Description

The current U.S. risk-based capital requirements for banking institutions are based on an internationally agreed framework for capital measurement developed by the Basel Supervisors Committee (BSC) in 1988. While it has been a stabilizing force for the international banking system, the world financial system has become increasingly more complex over the past fifteen years. The BSC has worked for some time to develop a more risk-sensitive capital framework, incorporating advances in risk measurement and management practices. On April 29, 2003, the BSC released for public consultation a document entitled "The New Basel Capital Accord" (New Accord). The New Accord encompasses three pillars: minimum regulatory capital requirements, supervisory review, and market discipline.

Office of Thrift Supervision has joined the other federal banking agencies in proposing for industry comment our current views on a proposed framework for implementing the New Accord in the United States. The framework is comprised of three companion documents that we expect will be published in the Federal Register in early August, but we have included it on our website today. They are (1) an Advance Notice of Proposed Rulemaking (ANPR), (2) Draft Supervisory Guidance on Internal Ratings-Based Systems for Corporate Credit (A-IRB), and (3) Supervisory Guidance on Operational Risk Advanced Measurement Approaches for Regulatory Capital (AMA). Together, the Advanced Internal-Ratings Based Approach for credit risk and the Advanced Measurement Approaches for operational risk are referred to as the advanced approaches. **These documents are complex and generally written to generate input from the technicians who would implement the concepts, but certain larger issues discussed below need your attention.**

The ANPR sets forth the proposed implementation of the new framework for the calculation of minimum regulatory risk-based capital requirements that uses a bank's or thrift's internal estimates of risk. It specifies criteria that would be used to determine which organizations would be required to use the advanced approaches, subject to meeting certain qualifying criteria, supervisory standards, and disclosure requirements. Other organizations that meet the criteria, standards, and requirements also would be eligible to use the advanced approaches on an elective basis.

The credit risk and operational risk charges will be combined to determine minimum regulatory capital requirements. The guidance on the IRB approach for credit risk is intended to provide supervisors and institutions with a clear description of the essential components and characteristics of an acceptable IRB framework, although it is not intended to dictate the precise manner by which institutions should seek to meet supervisory expectations. Since it focuses on corporate credit, guidance on retail credit, commercial

real estate lending, securitizations, and other portfolios will be issued at a later date. The guidance on operational risk sets forth the expectations for banking institutions using the AMA to calculate an operational risk capital charge. While the output of the regulatory framework for operational risk is a measure of exposure resulting in a capital number, the integrity of that estimate depends not only on the soundness of the measurement model, but also on the robustness of the institution's underlying risk management processes.

II. Points of Emphasis for Thrifts

The Agencies believe the advanced approaches are most appropriate for large, internationally active banking organizations. As a result, those institutions in the United States would be required to use the advanced approaches. The Agencies are proposing to identify three types of banking organizations: institutions subject to the advanced approaches on a mandatory basis (core institutions); institutions not subject to the advanced approaches on a mandatory basis, but that choose voluntarily to apply those approaches (opt-in institutions); and institutions that are not subject to and do not apply the advanced approaches (general institutions). Core institutions would be those with total assets of $250 billion or more or total on-balance-sheet foreign exposure of $10 billion or more.

General institutions (which the Agencies believe will be the vast majority of all U.S. banking and thrift organizations) would continue to apply the Agencies' existing risk-based capital rules. As a result, the United States would have a *bifurcated capital framework*, with two sharply distinct methodologies for institutions to calculate risk-weighted assets (the denominator of the risk-based capital ratios), where, in many cases, the assets held by general institutions are identical to institutions using the advanced approach. Among the questions asked in the ANPR are (a) whether alternative approaches, especially a single risk-based capital framework for all institutions would be more suitable, and, (b) assuming the advanced approach is adopted, how should the risk-based framework change for general institutions.

The Agencies, and OTS in particular, are keenly aware the advanced approaches of the New Accord may pose *competitive equity* concerns between relatively few core or opt-in institutions and general institutions, as well as non-banks. In particular, we welcome comment on whether the advanced approaches would confer pricing advantages, and whether they would prove to be a catalyst for industry consolidation. As a matter of *safety and soundness*, we are concerned about the potential impact on capital levels of individual thrifts, large and small, as well on capital levels in insured depository institutions in the aggregate. We urge you to consider, among the topics for your comment, these particular subjects:

1. **Would Basel II present a general disadvantage to your organization?**
2. **Should a single, risk-based system be devised for all institutions?**
3. **Would Basel II create pricing advantages for certain institutions?**
4. **Would Basel II promote further industry consolidation?**
5. **Would Basel II require the agencies to consider changes to the Prompt Corrective Action leverage ratio requirements?**

The ANPR and Guidance can be accessed at www.ots.treas.gov. The documents currently posted were approved by the Agencies but are subject to ongoing technical and non-substantive revisions until publication in the Federal Register. Questions regarding the proposed new framework may be directed to Michael D. Solomon, Senior Program Manager for Capital Policy, (202) 906-5654; David W. Riley, Project Manager (202) 906-6669; or Teresa A. Scott, Counsel (202) 906-6478.