

**Interagency Statement – U.S. Implementation of Basel II Framework  
Qualification Process - IRB and AMA  
January 27, 2005**

On June 26, 2004, the Basel Committee on Banking Supervision released its document "International Convergence of Capital Measurement and Capital Standards: A Revised Framework." The Framework (also referred to as Basel II) represents the outcome of the work of the Basel Committee to secure international convergence on revisions to regulations and standards governing the capital adequacy of internationally active banking organizations. On that same day, the U.S. banking and thrift agencies (collectively as "Agencies") issued a joint release outlining a comprehensive plan to incorporate the advanced risk and capital measurement methodologies of the Framework into regulations and supervisory guidance for U.S. institutions ("Institutions" in this interagency statement refers to banks, thrifts, and bank holding companies). The Agencies designed the plan to help ensure that implementation efforts are consistent with the Framework; reflect the unique statutory, regulatory and supervisory processes in the United States; and appropriately seek and consider comments on individual aspects of the plan from all interested parties.

The Agencies intend to continue providing information relating to the implementation of the Framework in the United States to all interested persons as quickly as it becomes available. The primary focus of this interagency statement is the appropriate scope and timing of institution-specific implementation plans and the Agencies' qualification process for the use of Framework-based rules to establish minimum regulatory capital requirements.

Information in this interagency statement is necessarily preliminary and is not intended to be binding on Institutions or on the Agencies. The Agencies recognize that no implementation efforts can be legally required in advance of the effective date of a final U.S. rule implementing the Framework. Nonetheless, the Agencies also appreciate the desire of Institutions to better understand, as soon as practicable, the Agencies' current expectations regarding implementation of the Framework and the corresponding process by which the Agencies will qualify Institutions. Recognizing that some Institutions want to begin preparations now in order to be best positioned to adopt the final rules at the earliest possible implementation date, the Agencies will continue to be as transparent as possible in describing current proposals to implement the Framework in the United States.

Ultimately, U.S. implementation will depend on, and will be subject to, final regulations and related policies promulgated by the Agencies, after public notice and consideration of comments from all interested parties. The Agencies remain unequivocally committed to fulfill all procedural requirements in working toward a final Framework-based regulation.

## **Recent Implementation Efforts**

The Agencies have made important progress on the implementation milestones outlined in the June 26th joint release. Most notably, the Agencies:

- On October 27, published for notice and comment supervisory guidance on Internal Ratings-Based Systems for Retail Credit (Retail IRB Guidance) [<http://edocket.access.gpo.gov/2004/pdf/04-23771.pdf> - PDF 234k ([PDF Help](#))];
- On October 25, made available spreadsheets, instructions and questionnaires relating to a fourth quantitative impact study (QIS-4) to evaluate the potential effects of a U.S. implementation of the Framework; [<http://www.ffiec.gov/qis4>]; and
- On October 25, made available spreadsheets and instructions relating to an operational risk loss data collection exercise (LDCE) to allow supervisors to better assess the completeness of internal loss data on which QIS-4 results are based [<http://www.ffiec.gov/ldce>].

Significant work remains for the Agencies on their implementation efforts, including the development of U.S. implementing regulations and additional supervisory guidance. Consistent with the timeframes discussed in the June 26th joint release, the Agencies expect that a notice of proposed rulemaking (NPR) on possible revisions to risk-based capital adequacy regulations relating to the Framework will be published in mid-2005. After fully considering all comments, the Agencies expect to be in a position to publish a final rule on this proposal in the second quarter of 2006. Possible changes to risk-based capital regulations for U.S. institutions not subject to the Framework-based regulations are expected to be considered in a timeframe that would allow them to become effective at the same time as the Framework-based regulations. Additionally, the Agencies continue to develop guidance for various portfolios and risk exposures addressed by the Framework.

## **Qualification Process**

This interagency statement is intended to summarize the process that the Agencies expect Institutions to use to qualify for the Framework's "advanced approaches" - the advanced internal ratings-based approach (IRB) for measuring credit risk and the advanced measurement approaches (AMA) for operational risk. While the Agencies expect that the forthcoming NPR and final rule will establish standards, the enormous

timing challenges to Institutions and the Agencies in developing, establishing, and approving the systems, processes and methodologies necessary under the Framework compel early disclosure of the Agencies' current thinking on the expected qualification process.

The Agencies have discussed in broad terms the qualification process they expect to employ in assessing Institutions' efforts to develop and implement IRB and AMA methodologies. Most directly, in the advance notice of proposed rulemaking (ANPR) published in August 2003, the Agencies stated that an Institution's "primary Federal supervisor would have responsibility for determining its readiness for an advanced approach and would be ultimately responsible, after consultation with other relevant supervisors, for determining whether the institution satisfies the supervisory expectations for the advanced approaches." 68 Fed. Reg. 45900, 45907 (August 4, 2003). In addition, the ANPR also highlighted the critical role of Institution implementation plans in the qualification process.

Consistent with that ANPR text, the Agencies have encouraged Institutions to develop detailed written implementation plans for IRB and AMA. For example, in the June 26, 2004 Joint Release, the Agencies stated, "[g]iven the investments needed to qualify for the advanced approaches of the Framework, the Agencies believe that it would be prudent for Institutions that expect to adopt the Framework on or near the effective date to begin planning their implementation efforts."

In view of the timing challenges, burden concerns, and practical considerations, this interagency statement focuses on Institution-specific implementation plans, assessment of those plans by appropriate supervisors, and the role of parallel running in the U.S. qualification process.

## **I. Timeline of Events**

In establishing a practical timeline for the qualification process, it is useful to work backwards, starting with the expected effective date of regulations implementing the Framework in the United States. Set forth below in reverse chronological order are the Agencies' current expectations for relevant milestones in the United States:

- January 2008 - Effective date of final regulations,
- January 2007 - First opportunity for "parallel run",
- Mid-year 2006 - Publication of final rule and updated guidance,
- Mid-year 2005 - Publication of NPR and updated guidance.

These milestones present enormous challenges for Institutions and supervisors. Accordingly, a number of Institutions have expressed interest in taking tangible steps towards qualification well before publication of final rules and guidance in order to be able to implement a Framework-based regime at the earliest possible time; the

Agencies are fully prepared to work with Institutions as they take preparatory steps. The Agencies view the development of detailed written implementation plans for IRB and AMA as among the most significant steps Institutions can take in advance of final rules and associated guidance.

## **II. Implementation Plans**

Implementation plans developed by Institutions will be a critical feature in the qualification process in the United States. Those plans would link existing Agency guidance with an Institution's specific implementation activities and would provide an initial basis for the development of supervisory plans related to the qualification process. As is detailed below, the Agencies intend to propose in the forthcoming NPR that Institutions' implementation plans should detail the necessary elements of rollout plans for the IRB and AMA.

The implementation plans should be approved by the board of directors of each affected Institution and discussed with its primary Federal regulator. The board of directors and senior management at each Institution has an obligation to understand its risk profile and ensure that those risks are properly managed and that its capital in respect of those risks is adequate.

The primary Federal supervisor's familiarity with an Institution's implementation plan, and with tangible actions pursuant to that plan, will greatly facilitate the IRB and AMA qualification process. The Agencies have established the following objectives for the incorporation of implementation plans in the qualification process:

- Implementation of the advanced approaches, including decisions relating to IRB and AMA qualification, should be "normalized" into the supervisory process of the Agencies. On the Agencies' part, this "normalization" will also involve the increased use of a diversity of skill sets in day-to-day supervision, especially including quantitative experts.
- The qualification of Institutions for the IRB and the AMA will be an iterative, on-going process. The Agencies intend to assess individual IRB and AMA methodologies through numerous discussions, reviews and examination activities. The Agencies also recognize the critical importance of on-going validation of IRB and AMA methodologies subsequent to initial qualification decisions.
- Implementation plans will serve as a critical communication instrument between Institutions and their home country, and various host-country, supervisors. However, neither Basel II, nor any implementing regulations, alters the legal responsibilities of home or host supervisors.

- Each of the Agencies expects to incorporate implementation plans into its quality assurance efforts to ensure consistent application of the Framework across Institutions, while ensuring that confidentiality of supervisory information is maintained. The Agencies expect to utilize Institution's self-assessments and remediation steps (described below) to facilitate peer analyses, and to take necessary steps to improve consistency of application and comparability of results.
- The Agencies expect to propose that the development of an effective implementation plan is a necessary - but not a sufficient - condition of the qualification process. Ultimately, full qualification will depend on successful execution of the implementation plan and actual operation of IRB and AMA systems consistent with supervisory standards.

In consideration of the objectives stated above, the Agencies intend to propose in the NPR that Institutions seeking to adopt Framework-based regulations:

- Adopt IRB and AMA implementation plans that:
  - Include a self-assessment by the Institution of its current status in meeting qualification standards of the Agencies;
  - Contain a gap analysis, based on the results of the Institution's self-assessment, that identifies and describes the areas in which it needs to undertake additional work;
  - Include a remediation (or action) plan describing the manner by which the institution would address the areas identified in the gap analysis and undertake the necessary work to resolve shortcomings;
  - Identify objectively measurable milestones, including delivery dates;
  - Demonstrate that adequate resources would be realistically budgeted and made available;
  - Receive board of director endorsement and approval at each Institution; and
  - Form the basis for regular discussion with the primary Federal regulator.
- Develop and maintain a comprehensive and sound planning and governance process to oversee implementation efforts and to support development of tangible implementation plans for IRB and AMA.
- Adopt IRB and AMA implementation plans that are comprehensive, addressing the implementation requirements for all relevant legal entities, whether they are U.S.- or foreign-based, including a description of all required supervisory approvals. As stated in the ANPR, Institutions adopting Framework-based regulations would have to apply the IRB and AMA across all material business lines, portfolios and geographic regions. Exposures in non-significant business units, as well as asset classes that are immaterial in terms of size and perceived risk profile, may be exempted from the IRB and AMA only with approval of the primary Federal supervisor.

With the publication of the Retail IRB guidance, the Agencies have now issued in draft form three critical pieces of supervisory guidance - Corporate IRB, Retail IRB, and AMA. Many Institutions that expect to adopt the Framework on or near the effective date have already commenced planning their implementation efforts, based on this guidance. The QIS-4 process, including Agency feedback on submissions, will provide Institutions with additional insight on the Agencies' overall plans for implementation of the Framework.

The Agencies encourage Institutions that expect to adopt the Framework on or near the effective date to move forward with their efforts and begin development of tangible IRB and AMA implementation plans at the earliest possible date. To assist in those efforts, the Agencies are available to discuss implementation plans at any time. The Agencies believe that an Institution could help ensure adequate time for supervisory review of its implementation plan prior to the effective date of the Framework-based capital rule by making an initial iteration of the implementation plan available to its primary Federal regulator by the third quarter of 2005.

### **III. Notification Process**

As discussed in the ANPR, the Agencies intend to propose that the United States have a bifurcated regulatory capital regime after implementation of the Framework. That is, once planned rulemaking efforts are completed, we anticipate that two distinct methodologies will be available for the calculation of regulatory risk-based capital requirements - one based on the Framework and the other using an updated version of our existing Capital Adequacy regulations. We anticipate that the leverage ratio will continue to apply to all Institutions.

To ensure that the primary Federal supervisor is fully informed of planned implementation efforts, it is anticipated that an Institution would be required to file formal notification of its intent to comply with Framework-based regulations in the calculation of its regulatory capital requirements, including a proposed timeframe for the adoption of IRB and AMA methodologies. Under such a proposal, an Institution would submit a notice with the primary Federal supervisor at least 18 months before the expected adoption of Framework-based regulations (which would allow for a one-year parallel run, as described below). The notification could incorporate any documents previously provided to the Agencies, including IRB and AMA implementation plans. The primary Federal regulator is expected to respond to the notice during the Institution's parallel run period and communicate the decision as to whether the Institution is approved to make use of its IRB and AMA methodologies in the calculation of its regulatory capital requirements.

According to current proposals, Institutions not meeting the mandatory criteria at the

time of the final rule, i.e., opt-in Institutions, would not be compelled to fulfill any of the requirements of Framework-based regulations in the United States, but would have the option of implementing them voluntarily. Should an Institution choose to opt-in, it would be subject to the same qualification requirements that would apply to mandatory institutions, including the requirement to give proper prior notice. However, opt-in Institutions would be allowed to delay or abandon their implementation of the Framework-based requirements at any time before they are fully qualified.

#### **IV. Parallel Running**

The Agencies expect to propose that, for at least one full year prior to using its IRB and AMA systems for the determination of minimum regulatory risk-based capital requirements, an Institution must conduct a parallel run of those systems in a manner acceptable to the primary Federal supervisor. Under such a proposal, an Institution that intends to apply IRB and AMA methodologies beginning in 2008 would need to have fully implemented the necessary systems for use throughout 2007, including appropriately addressing all remedial actions previously identified by supervisory staff. This would allow the primary Federal regulator to observe those systems in actual operation and would provide useful quantitative information about the revised regulatory capital requirements during the period prior to their first use for regulatory capital purposes.

Under this approach, the supervisory review of the parallel run process would provide the basis for the primary Federal supervisor's qualification decisions. Affirmative qualification during the parallel run period would be necessary to use the IRB and AMA results for regulatory risk-based capital purposes on a going-forward basis. While supervisors expect to have ongoing and substantial interaction with Institutions on all aspects of their implementation plans and processes, there is no specific approval required to begin parallel running. In order to conduct a credible parallel run, the Agencies expect that the systems underlying the advanced approaches would be operating on a stable basis, with inputs derived from reliable and well-established data sets.

The Agencies intend to propose that during the parallel run period, Institutions would be required to report the results of their IRB and AMA systems to their primary Federal regulator on a quarterly basis. As with implementation plans, this information would be considered as part of the normal supervisory process and be kept confidential in accordance with applicable law. As noted above, the Agencies expect to propose that an Institution be notified by its primary Federal supervisor at some point during the parallel run period as to whether it would be permitted to apply the IRB and AMA approaches in the calculation of risk-based regulatory capital.

## **V. Next Steps**

The Agencies intend to provide further and more formal clarification of a proposed IRB and AMA qualification process in the forthcoming NPR. In the meantime, Agency staffs are willing to meet with any Institution that wants to discuss methods of enhancing current IRB and AMA systems and processes. The Agencies recognize that the Framework-based capital rule is still in development and that the initial qualification process for individual Institutions may take more than a year.

The Agencies have made, and will continue to make, every effort to offer information and assistance to all Institutions interested in implementing the new Framework - this includes those Institutions meeting the proposed "mandatory" criteria, as well as opt-in Institutions. In this manner, the Agencies have provided a substantial amount of public information relating to the proposed adoption of the Framework-based rules, have met with Institutions on an individual basis to discuss the proposals and Institutions' preparatory work, and have allowed access to several Basel II-related activities (such as QIS4 and LDCE exercises) to any Institution wishing to participate. The Agencies remain committed, for the entirety of the Basel II implementation and qualification process, to provide equal access to information about U.S. adoption of the Framework-based rules, and to meet and discuss with any and all Institutions interested in preparatory work for Basel II.

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Questions or comments on the above materials are welcome. Institutions are encouraged to contact their examiner-in-charge, central point of contact, dedicated examiner, or other similar supervisory personnel. Other interested persons may address comments or questions to the following agency contacts:

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