Interagency Statement – U.S. Implementation of Basel II Advanced Approaches Framework

Qualification Process

On December 7, 2007, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (collectively, the agencies) issued a new risk-based capital framework (advanced approaches rule) that requires some and permits other qualifying banks[1] to use an internal ratings-based approach (IRB) and other methodologies to calculate risk-based capital requirements for credit risk and advanced measurement approaches (AMA) to calculate risk-based capital requirements for operational risk.[2] Collectively, these methodologies are referred to as the advanced approaches. The rule describes the qualification requirements for banks required or seeking to operate under the new framework and the applicable risk-based capital requirements. The rule became effective April 1, 2008.

This interagency statement outlines the qualification process that banks planning to operate under the advanced approaches rule must follow. This process includes actions on the part of the banks as well as the agencies. A key initial action for each bank is the development, adoption, and execution of a detailed implementation plan.

Qualification Process

The qualification process consists of three major stages: (i) adoption of a bank's board of directors-approved implementation plan; (ii) completion of a satisfactory parallel run; and (iii) advancement through the three distinct transitional periods. There are also a number of options and elective matters (e.g., obtaining supervisory approval to use a model for certain types of exposures) that banks may need to address with their primary Federal supervisor during the qualification process.

I. Implementation Plan

A) Bank Actions

As set forth in the advanced approaches rule, each bank that plans or is required to use the advanced approaches rule must adopt a board-approved 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 a BHC that plans or is required to use the advanced approaches rule. The implementation plan is a critical feature and necessary first step in the qualification process. While DI exemptions from application of the advanced approaches rule may be granted by a DI's primary Federal supervisor, it is expected that such exemptions will be infrequent.

A bank's implementation plan must address comprehensively all qualification requirements set forth in section 22 of the advanced approaches rule[3] and should include, in particular, how the bank will implement Pillar 2 (including its internal capital adequacy assessment process (ICAAP)) and Pillar 3 (public disclosure).

A bank's implementation plan is a tangible representation of how it complies or plans to comply with the rule. The agencies recognize that a variety of formats may be used in presenting the implementation plan, including a consolidated plan with an appendix or attachment structure to cover the specifics of the subsidiaries,[4] or individual plans for each DI under a holding company. Regardless of the format, the key is that the plan(s) address the qualification requirements for each legal entity subject to the advanced approaches rule.

In developing an implementation plan, a bank must assess its current state of readiness relative to the qualification requirements. As described in the advanced approaches rule, the plan must:

- Comprehensively address the qualification requirements in the rule for the bank and each consolidated subsidiary of the bank with respect to all portfolios and exposures;
- Justify and support any proposed temporary or permanent exclusion of business lines, portfolios, or exposures from the application of the advanced approaches rule;
- Include a self-assessment of:
  - The bank's current state of meeting the qualification requirements; and
  - The consistency of the bank's current practices with the agencies' supervisory guidance on the qualification requirements;[5]
- Include a gap analysis identifying and describing the areas in which the bank proposes to undertake additional work to comply with the qualification requirements or to improve the consistency of the bank's current practices with the agencies' supervisory guidance on the qualification requirements;
- Describe what specific actions the bank will take to address the areas identified in the gap analysis;
- Identify objective, measurable milestones, including delivery dates and a date when the bank's implementation of the methodologies will be fully operational;
- Describe resources that have been budgeted and are available to implement the plan; and
- Receive approval from the bank's board of directors.

Because the implementation plan (including the gap analysis) is the only requirement to enter parallel run, the agencies have high expectations for its overall quality and the reasonableness of the approach taken by a bank in assessing its current state of readiness. Plans should be provided directly to the primary point of contact at each bank's primary Federal supervisor (e.g., the Examiner-in-Charge or Central Point of Contact). In addition, if the bank makes any material changes to the plan after it has been approved by the board of directors, the bank should resubmit the plan to its primary point of contact.

With respect to timing, the advanced approaches rule establishes some key deadlines that banks will need to observe. Banks required to implement the advanced approaches rule (core banks)[6] must adopt their board-approved implementation plan within six months of the effective date of the rule (i.e., October 1, 2008) or within six months of becoming a core bank, whichever is later. Banks electing to opt-in to the advanced approaches rule may adopt their board-approved implementation plan at any time. Every bank seeking to operate under the advanced approaches rule must submit its implementation plan to its primary Federal supervisor at least 60 days before the start of its parallel run, unless the agency has waived the prior notification requirement. Parallel run may begin on the first day of any calendar quarter. If a bank plans to seek a waiver of the 60-day notification requirement, it should make its primary Federal supervisor aware of its intentions as soon as practicable. The bank should also be prepared to describe why it is seeking the waiver, as well as its current state of preparations for complying with the advanced approaches rule.

For core banks, the implementation plan must include an explicit first transitional floor start date that is no later than 36 months after the effective date of the rule (i.e., April 1, 2011) or the date the bank meets at least one of the threshold criteria to become a core bank, whichever is later.[7]

B) Primary Federal Supervisor Actions

The implementation plans will be a key element in how supervisors engage the banks before and during parallel run. In order to provide constructive feedback and direction as early as possible, banks may submit draft implementation plans for initial supervisory feedback prior to the submission of each plan to each bank's board.

Upon receipt of a bank's board-approved implementation plan, the primary Federal supervisor first will determine whether the plan meets the requirements of the advanced approaches rule. As part of this process, the agencies will provide feedback to their respective banks regarding the comprehensiveness and reasonableness of the plan prior to the start of parallel run. Initial feedback also will be provided on areas or issues that could affect a successful parallel run period. More robust feedback will be provided once the bank has initiated its parallel run and the primary Federal supervisor has the opportunity to observe the plan in action. The primary Federal supervisor will assess individual IRB, AMA, and other methodologies through ongoing examination activities and discussions and will continue to provide relevant feedback throughout that process.

Implementation plans will provide the basis for supervisory strategies and examination planning during a bank's parallel run. To the highest degree possible, required supervisory actions will be incorporated into ongoing supervisory activities related to credit and operational risk management and assessments of capital adequacy.

The content of implementation plans constitutes critical information that will serve to foster enhanced communication domestically among the agencies and internationally with host or home country supervisors. Such communication among the agencies will facilitate consistent application of the rule across U.S. banks. On an international basis, this communication will allow for a more coordinated approach to overall qualification while maintaining established confidentiality requirements and recognizing the legal responsibilities of home and host supervisors.

II. Parallel Run

Parallel run is the period during which banks must demonstrate that their IRB, AMA, other methodologies, and ICAAP systems and processes are working, subject to only minor modifications and adjustments. As provided in the advanced approaches rule, a bank must complete a satisfactory parallel run before it may use the new risk-based capital framework to calculate its risk-based capital requirements. During the parallel run, a bank will continue to be subject to the general risk-based capital rules[8] for all regulatory, supervisory and reporting purposes, but also will report to its primary Federal supervisor its risk-based capital as calculated according to the advanced approaches rule.

The advanced approaches rule defines a satisfactory parallel run as a period of at least four consecutive calendar quarters during which a bank complies with the qualification requirements to the satisfaction of its primary Federal supervisor. The only explicit requirement that a bank must meet prior to starting its parallel run is that it submit a board-approved implementation plan that meets the requirements of section 21 to the primary Federal supervisor at least 60 days prior to the start of parallel run. However, a bank should not consider beginning parallel run until it expects to be in a position to demonstrate compliance with the qualification requirements detailed in section 22 of the advanced approaches rule for at least four consecutive calendar quarters. Parallel run may be extended beyond four quarters if the bank has not demonstrated that it is meeting the qualification requirements of the rule. If the primary Federal supervisor determines that a bank is not meeting the qualification requirements to its satisfaction at any point during the parallel run, the quarter may not be considered satisfactory.

As primary Federal supervisors, the agencies expect to have frequent and ongoing interactions with banks during the parallel run. They will perform significant targeted work to ensure that banks are executing their implementation plans to meet the qualification requirements. During this time, banks should expect to receive feedback on their advanced systems, their ICAAP and the completed quarterly (FFIEC 101)[9] regulatory reports, which will remain confidential during parallel run. Feedback will be written and oral, with the key emphasis on providing banks with the critical information needed to comply with the advanced approaches rule and to move toward qualification.

III. Transitional Floor Periods

The primary Federal supervisor's approval for a bank to move to the first transitional floor period will be based on an assessment of the bank's compliance with all the qualification requirements of the advanced approaches rule, including having a satisfactory ICAAP in place. In addition, a bank must have been providing the FFIEC

101 regulatory reports as required during the four (or more) quarters of parallel run. The criteria used to approve banks are the same across the agencies, and the agencies will continue to coordinate their supervisory efforts, in much the same manner as is done currently on other issues of mutual interest.

Once a bank has demonstrated that it has met the qualification requirements for four consecutive quarters (i.e., completed a satisfactory parallel run), and there are processes in place to ensure ongoing compliance with the qualification requirements, the primary Federal supervisor will notify the bank that it has qualified to use the advanced approaches rule for risk-based capital purposes and will identify the start date for the bank's first transitional floor period.

To provide for a smooth transition to the new risk-based capital framework, the advanced approaches rule imposes a graduated series of limits on the amount by which a bank's risk-based capital requirements could decline during a transition period. These limits are expressed as a percentage of risk-weighted assets as calculated under the general risk-based capital rules. A bank may not move from one transitional floor period to the next until it has spent a minimum of four consecutive calendar quarters in the transitional period and it has received approval from its primary Federal supervisor. In addition to the completion of the four calendar quarters, the agencies will consider the bank's ability to demonstrate that it continues to meet the qualification requirements of the advanced approaches rule. Table 1 sets forth the transitional floor percentages:

Table 1 – Transitional Floors

Transitional floor period	Transitional floor percentage
First floor period	95 percent
Second floor period	90 percent
Third floor period	85 percent

As specified in the advanced approaches rule, during the transitional floor periods a bank must report five capital ratios – risk-based capital ratios as calculated under the advanced approaches rule, risk-based capital ratios calculated subject to the relevant floor identified above, and the tier 1 leverage ratio. These ratios will be reported in the Call Report and in the FFIEC 101 reports.

The primary Federal supervisor will determine when a bank may move to the stand-alone use of the advanced approaches rule to calculate its risk-based capital requirements, thus concluding the third transitional period. The primary Federal supervisor's determination will be based on an assessment of the bank's ongoing compliance with all the qualification requirements. The agencies expect that banks will continue to refine and improve their advanced approaches systems and processes throughout the transition periods and on an ongoing basis, but that the qualification criteria will be met throughout. Banks are required to spend a minimum of four consecutive quarters in each of the transitional floor periods.

In addition, the advanced approaches rule states that after the end of the second transition year (2010), the Federal banking agencies will publish a study that evaluates the advanced approaches to determine if there are any material deficiencies. For any primary Federal supervisor to authorize any institution to exit the third transitional floor period, the study must determine that there are no such material deficiencies that cannot be addressed by then-existing tools, or, if such deficiencies are found, they are first remedied by changes to this appendix. Notwithstanding the preceding sentence, a primary Federal supervisor that disagrees with the finding of material deficiency may not authorize any institution under its jurisdiction to exit the third transitional floor period unless it provides a public report explaining its reasoning.

IV. Other Matters

A) Validation

Validation is a critically important requirement in the advanced approaches rule. As articulated in the advanced approaches rule, validation is a broad concept encompassing evaluation of conceptual soundness, ongoing monitoring and outcomes analysis. As such, validation includes independent point-in-time assessments as well as ongoing activities to ensure that individual models, as well as the overall advanced systems, are operating as intended. A bank must be able to demonstrate that it has performed the full range of validation processes related to all areas of its advanced systems. While agency reviews of bank models and processes are a necessary part of the supervisory review process, these reviews do not constitute validation activities as required by the rule.

Many of the concepts outlined in the advanced approaches rule's validation section (section 22(j)(4)) reflect longstanding supervisory expectations for individual model development, validation and implementation. However, the rule includes additional requirements regarding the qualitative aspects as well as the overall soundness of the validation process. Just as evidence of a strong and effective validation framework is a critical requirement that must be satisfied to achieve a satisfactory parallel run, a robust and evolving validation framework is critically important for successful advancement through the transitional floor periods and on an ongoing basis.

B) Changes to Advanced Systems

A bank must meet all the qualification requirements of the advanced approaches rule on an ongoing basis. A bank must notify its primary Federal supervisor if it makes any change to an advanced system that would result in a material change in the bank's risk-weighted asset amount for an exposure type, or when it makes any significant change to its modeling assumptions.

C) Exemption from the Advanced Approaches Framework

Section 1(b) of the advanced approaches rule outlines the criteria that determine the banks that are required to adopt the advanced approaches for calculating their minimum risk-based capital requirements. Under section 1(b)(3), the primary Federal supervisor may exempt a bank that otherwise is required to adopt the advanced approaches rule if the supervisor determines, in writing, that the application of the advanced approaches rule is not appropriate in light of the bank's asset size, level of complexity, risk profile, or scope of operations. To make a determination according to these criteria, the primary Federal supervisor will consider a number of factors, including:

- The bank's asset size, scope of operations, and risk profile relative to any consolidated parent company subject to the advanced approaches rule,
- The complexity of the bank's operations;
- The credit and/or operational risk profile of the bank;
- The bank's scope of operations; and
- Any other unique features of the bank.

If a bank wishes to obtain an exemption from the advanced approaches rule, it should discuss this option with its primary Federal supervisor prior to submitting an implementation plan for the consolidated entity. Supervisory exemptions from the advanced approaches rule are expected to be granted on an infrequent basis.

D) Mergers and Acquisitions

Within 90 days of consummating a merger or acquisition, a bank must submit to its primary Federal supervisor an implementation plan for using its advanced systems for the acquired company. That plan must articulate how the bank intends to incorporate the acquired exposures into its advanced systems within 24 months of the merger or acquisition. If the acquired bank is already using its own advanced systems, the acquiring bank may continue to use those systems to calculate capital during the transition period. For acquisitions in which the acquired bank does not use advanced systems, capital for the acquired bank's exposures must be calculated and reported under the general risk-based capital rules until such exposures may be incorporated appropriately into the advanced systems of the acquiring bank, subject to the timeframes in the rule.

In the event that a merger or acquisition takes place while the bank is preparing its initial implementation (i.e., before October 2008), the rules identified above remain relevant. The bank is not required to take special steps to ensure that the prospective merger is reflected in the initial implementation plan; the bank simply must meet the 90 day requirement for the merged or acquired institution.

E) Supervisory Decisions Related to the Advanced Approaches Rule

The following are critical decision points for supervisors:

- Assessment of board-approved implementation plan;
- Determination of satisfactory parallel run;
- Determination to exit parallel run; and
- Determination to exit each floor period.

The timing of these supervisory decisions and related supervisory activities will be aligned with receipt of a board-approved implementation plan and timelines contained in the implementation plan. The primary Federal supervisor will develop and communicate to bank management a supervisory plan for qualification to use the advanced approaches rule. The supervisory plan will be coordinated with relevant supervisors to the fullest extent possible to minimize the regulatory burden to banks.

Minimum documentation to support supervisory qualification decisions include: (a) a board-approved implementation plan with self assessment; (b) FFIEC 101 reports; and (c) an internal audit report furnished to the board that assesses the effectiveness of the controls supporting the advanced systems.

The primary Federal supervisor will provide written communications to the bank's board of directors informing it of the supervisory decisions to permit the bank to exit the parallel run period and final transitional floor period. Other approvals and communications will be made through the normal supervisory process.

Appeals of supervisory qualification decisions should be made in accordance with existing appeals processes of the agencies.

F) Additional Considerations

There are a number of areas within the advanced approaches rule where supervisory approval is required before a bank may use a specific process or methodology in applying the advanced approaches rule. These include:

- Internal models methodology for counterparty credit risk;
- Double default treatment;
- Internal Assessment Approach for securitization exposures to asset-backed commercial paper programs;
- Internal Models Approach for equity exposures;
- A period of less than five years of internal operational loss event data in the bank's AMA to address transitional situations; and
- An alternative operational risk quantification system to generate an estimate of operational risk exposure.

If a bank plans to incorporate any of these approaches when it begins adopting the advanced approaches, the approvals will be part of the standard qualification process and the bank should identify clearly its plans regarding these methodologies in the board-approved implementation plan. If a bank subsequently seeks to use one of these approaches, the bank will need to notify its primary point of contact at its primary Federal supervisor in writing that it is requesting such approval.

Agency Communication

The agencies have made, and will continue to make, every effort to offer information and assistance to all banks required to or interested in implementing the advanced approaches rule. The agencies reaffirm their commitment to provide equal and full access to information about U.S. adoption of the advanced approaches rule, and to meet with any and all banks interested in or required to implement the rule.

As banks begin implementation, the agencies recognize that questions will be raised. These questions should be shared with the resident supervisory teams, who will coordinate with appropriate supervision, policy, legal, and quantification experts to ensure an appropriate response. The agencies also are coordinating, on an interagency basis, responses on issues related to broader policy and interpretative matters.

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[1] For simplicity, and unless otherwise indicated, the advanced approaches rule and this guidance use the term "bank" to include banks, savings associations, and bank holding companies (BHC). The terms "bank holding company" and "BHC" refer only to bank holding companies regulated by the Board and do not include savings and loan holding companies regulated by the OTS.

[2] The regulatory capital requirements in the advanced approaches rule apply to a bank's calculation of minimum risk-based capital requirements for credit risk and operational risk. If the bank is also subject to the market risk capital rule, then the minimum risk-based capital requirements in that rule would also apply to the bank.

[3] See 12 CFR Part 3, Appendix C (OCC); 12 CFR Part 208, Appendix F (Board); 12 CFR Part 225, Appendix G (Board); 12 CFR Part 325, Appendix D (FDIC); and 12 CFR Part 567, Appendix C (OTS)

[4] In formulating implementation plans, internationally active banks should give consideration to the development of country implementation plans to help facilitate communication with host supervisors.

[5] This bullet refers only to guidance that the agencies have finalized and published for use by the banks.

[6] Under the advanced approaches rule banks with at least $250 billion of consolidated total assets, at least $10 billion of on-balance sheet foreign exposure, or that are a parent or subsidiary of a bank using the advanced approaches are core banks.

[7] The bank's primary Federal supervisor may extend the bank's first transitional floor start date.

[8] 12 CFR part 3, Appendix A (OCC); 12 CFR parts 208 and 225, Appendix A (Board); 12 CFR part 325, Appendix A (FDIC); and 12 CFR part 567 subpart B (OTS).

[9] FFIEC 101: Risk-Based Capital Reporting for Institutions subject to the Advanced Capital Adequacy Framework (www.ffiec.gov). Upon the start of a bank's parallel run, the primary Federal supervisor will work with the bank to establish appropriate mechanisms for submission of the FFIEC 101 regulatory reports.

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