

appropriate approach. The Federal Reserve is actively considering several approaches to the capital treatment for investments by bank holding companies in insurance underwriting subsidiaries. For example, the Federal Reserve is currently assessing the merits and weaknesses of an approach that would consolidate an insurance underwriting subsidiary's assets at the holding company level and permit excess capital of the subsidiary to be included in the consolidated regulatory capital of the holding company. A deduction would be required for capital that is not readily available at the holding company level for general use throughout the organization.

The Federal Reserve specifically seeks comment on the appropriate regulatory capital treatment for investments by bank holding companies in insurance underwriting subsidiaries as well as other nonbank subsidiaries that are subject to minimum regulatory capital requirements.

Transitional Arrangements

Core and opt-in banks would be required to calculate their capital ratios using the A-IRB and AMA methodologies, as well as the general risk-based capital rules, for one year prior to using the advanced approaches on a stand-alone basis. In order to begin this parallel-run year, however, the institution would have to demonstrate to its supervisor that it meets the supervisory standards. Therefore, banking organizations planning to meet the January 1, 2007 target effective date for implementation of the advanced approaches would have to receive approval from their primary Federal supervisor before year-end 2005. Banking organizations that later adopt the advanced approaches also would have a one-year dual calculation period prior to moving to stand-alone usage of the advanced approaches.

An institution would be subject to a minimum risk-based capital floor for two years following moving to the advanced approaches on a stand-alone basis. Specifically, in the first year of stand-alone usage of the advanced approaches, an institution's calculated risk-weighted assets could not be less than 90 percent of risk-weighted assets calculated under the general risk-based capital rules. In the following year, an institution's minimum calculated risk-weighted assets could not be less than 80 percent of risk-weighted assets calculated under the general risk-based capital rules.¹²

As a consequence, advanced approach banking organizations would need to conduct two sets of capital calculations for at least three years. The pre-implementation calculation of A-IRB and AMA capital would not need to be made public, but the banking organization would be required to disclose risk-based capital ratios calculated under both advanced and general risk-based approaches during the two-year post-implementation period. The Agencies would not propose to eliminate the floors after the two-year transition period for any institution applying the advanced approaches until the Agencies are fully satisfied that the institution's systems are sound and accurately assess risk and that resulting capital levels are prudent.

These transitional arrangements and the floors established above relate only to risk-based capital ratios and do not affect the continued applicability to all advanced banking organizations of the leverage ratio and associated PCA regulations for banks and thrifts. Importantly, the minimum capital requirements and the PCA thresholds would not be changed. Furthermore, during the implementation period and before removal of the floors the Agencies intend to closely monitor the effect that the advanced approaches would have on capital levels at individual institutions and industry-wide capital levels. Once the results of this monitoring process are assessed, the Agencies may consider modifications to the advanced approaches to ensure that capital levels remain prudent.

Given the general principle that the advanced approaches are expected to be implemented at the same time across all material portfolios, business lines, and geographic regions, to what degree should the Agencies be concerned that, for example, data may not be available for key portfolios, business lines, or regions? Is there a need for further transitional arrangements? Please be specific, including suggested durations for such transitions.

risk-weighted assets. The Agencies expect that the final language of the New Accord would need to be consistent with this approach. The following example reflects how the floor in the first year would be applied by a U.S. banking organization. If the banking organization's general risk-based capital calculation produced risk-weighted assets of \$100 billion in its first year of implementation of the advanced approaches, then its risk weighted assets in that year could not be less than \$90 billion. If the advanced approach calculation produced risk-weighted assets of \$75 billion (a decrease of one quarter compared to the general risk-based capital rules), the organization would not calculate risk-based capital ratios on the basis of that \$75 billion; rather, its risk-weighted assets would be \$90 billion. Consequently, its minimum total risk-based capital charge would be \$7.2 billion, and it would need \$9 billion to satisfy PCA well-capitalized criteria.

Do the projected dates provide an adequate timeframe for core banks to be ready to implement the advanced approaches? What other options should the Agencies consider?

The Agencies seek comment on appropriate thresholds for determining whether a portfolio, business line, or geographic exposure would be material. Considerations should include relative asset size, percentages of capital, and associated levels of risk for a given portfolio, business line, or geographic region.

III. Advanced Internal Ratings-Based (A-IRB) Approach

This section describes the proposed A-IRB framework for the measurement of capital requirements for credit risk. Under this framework, banking organizations that meet the A-IRB infrastructure requirements and supervisory standards would incorporate internal estimates of risk inputs into supervisor-provided capital formulas for the various debt and equity portfolios to calculate the capital requirements for each portfolio. The discussion below provides background on the conceptual basis of the A-IRB approach and then describes the specific details of the capital formulas for two of the main exposure categories, wholesale and retail. Separate sections follow that describe the A-IRB treatments of loan loss reserves and partial charge-offs, the A-IRB treatment of purchased receivables, the A-IRB treatment of equity exposures, and the A-IRB treatment of securitization exposures. The A-IRB supervisory requirements and the A-IRB approach to credit risk mitigation techniques also are discussed in separate sections.

A. Conceptual Overview

The A-IRB framework has as its conceptual foundation the belief that any range of possible losses on a portfolio of credit exposures can be represented by a probability density function (PDF) of possible losses over a one-year time horizon. If known, the parameters of a PDF can be used to specify a particular level of capital that will lower the probability of the institution's insolvency due to adverse credit risk outcomes to a stated confidence level. With a known or estimated PDF, the probability of insolvency can be measured or estimated directly, based on the level of reserves and capital available to an institution.

The A-IRB framework builds off this concept and reflects an effort to develop a common set of risk-sensitive formulas for the calculation of required capital for credit risk. To a large extent, this framework resembles more systematic quantitative approaches to the

¹² The agencies note that the text above differs from the floor text in the New Accord, which is based on 90 and 80 percent of the minimum capital requirements under the 1988 Accord, rather than on