

Financial Services Alert

Goodwin Procter LLP, a firm of 700 lawyers, has one of the largest financial services practices in the United States.

New Subscribers, Past Issues and Background

Material: If you would like anyone else to receive issues of the Financial Services Alert, would like to receive any past issues, or would like the background materials for any of the matters discussed in this issue, please contact **Greg Lyons, Eric Fischer, Elizabeth Shea Fries** or **Jackson Galloway** at 617.570.1000 or at the e-mail addresses referenced at the end of this newsletter.

Alert on the Web:

Back issues of the *Alert* are available at www.goodwinprocter.com/Publications/Financial%20services%20Alerts.aspx

Disclaimer:

This publication, which may be considered advertising under the ethical rules of certain jurisdictions, is provided with the understanding that it does not constitute the rendering of legal advice or other professional advice by Goodwin Procter LLP or its attorneys.

©2007 Goodwin Procter LLP
All rights reserved.

In this issue:

Developments of Note

1. Banking Agencies Publish Supplemental Guidance on Basel II—Operational Risk Advanced Measurement Approach
2. FRB Grants Exemption from Section 23A Related to Securities Lending as Principal
3. DOL Issues Interim Final Rule Regarding Statutory Exemption for Cross-Trading
4. FDIC Proposes Assessment Adjustment Guidelines for Large Banks and Insured Foreign Branches
5. BIS Publishes Home-Host Guidance Relating to Operational Risk Advanced Measurement Approach

Developments of Note

➤ Banking Agencies Publish Supplemental Guidance on Basel II—Operational Risk Advanced Measurement Approach

As discussed in last week's *Alert*, the four federal banking agencies published extensive proposed supervisory guidance documents (the "Supervisory Guidance") meant to supplement the US Basel II Advanced Capital Adequacy Framework (the "Advanced Framework") notice of proposed rulemaking issued ("NPR") on September 25, 2006. The Supervisory Guidance covers three distinct areas: (1) internal risk based systems for credit risk; (2) the operational risk advanced measurement approach (the "AMA"); and (3) the supervisory review process for the Advanced Framework. Last week's article focused on the third area, and this article focuses on the second component, the AMA. Comments on all aspects of the proposal are due within 90 days of its publication in the *Federal Register*.

The AMA guidance is divided into five principal subparts: (1) operational risk management ("Risk Management"), (2) operational risk data and assessment ("Data and Assessment"), (3) operational risk quantification ("Quantification"), (4) data management and maintenance ("Data Management"), and (5) verification and validation ("Verification"). The AMA guidance is intended to provide the supervisory standards banks should follow to implement the AMA, but the guidance emphasizes that banks "will have considerable flexibility" in developing these subparts. The banking agencies will exercise supervisory judgment over both the individual subparts and the overall AMA system, and that system will be assessed as part of the ongoing supervision process (regulators will "make every effort to leverage [ongoing] examination activities" in evaluating AMA). The guidance warns that regulators will assess the affects of mergers and acquisitions on AMA. As to timing, a bank that becomes subject to the AMA rules must adopt a written implementation plan no later than 6 months after the later of (1) the effective date of the final rule, or (2) the date the bank meets one of the applicability criterion of the final rule. A summary of the five principal subparts follows.

Risk Management. Risk Management focuses largely on the need for banks to develop an operational risk management function. Three key components should be evident: a firm-wide risk management function, line of business management, and an independent audit function. The Risk Management process should be documented (as detailed in the guidance) and the Board of Directors (which, along with management, provide the "cornerstone of the system") must at least annually evaluate the effectiveness of, and approve, the AMA system. The Board of Directors and senior management should receive reports on Risk Management at least quarterly.

Data and Assessment. The guidance discusses that a bank's systems must be able to credibly and systematically capture 4 elements on an ongoing basis (and provides detailed information as to what data must be captured in each element): (1) internal operational loss event data; (2) relevant external data; (3) scenario analysis; and (4) the bank's business environment. The internal loss data must have an observation period of at least 5 years, vary in detail as to each event depending on the size of the loss, and be captured consistently across all the bank's business lines, corporate functions, events, products types, and geographic locations. As to external data, the bank must have a process to determine how external data will be incorporated into the AMA, and should review the external data to ensure an understanding of industry loss experience. The bank also must have a systematic process for determining how scenario analyses (*i.e.*, expert opinions from business and risk managers) will be incorporated into its AMA. These scenario analyses are particularly important in business lines where other data do not provide a sufficiently robust estimate of the bank's operational risk exposure. The fourth element, business environment (and internal control factors), should be used to identify positive and negative trends in operational risk management within the bank.

Quantification. The guidance first reiterates that a bank's AMA, using the Data and Assessment inputs described above, must provide an estimate of the bank's operational risk exposure, "which is defined as the 99.9th percentile of the distribution of potential aggregate operational losses over a one-year horizon." The estimate must include both expected operational loss ("EOL") and unexpected operational loss ("UOL"), as well as qualitative factors such as changes in business environment. The dollar risk-based capital requirement is then equal to the greater of (1) the bank's exposure, adjusted for qualifying risk mitigants (*e.g.*, insurance, provided that this adjustment generally is limited to 20% of overall exposure) minus eligible risk offsets (subject to supervisory approval, and only up to the EOL), or (2) 0.8 multiplied by the difference between the bank's exposure and risk offsets. The analytical framework the bank uses to generate these inputs must be re-evaluated whenever a change occurs that could have a material affect on those inputs, and in any event at least annually. A bank is permitted to seek to demonstrate to regulators the dependence of various inputs in calculating aggregate exposure, otherwise it must simply aggregate all exposures across business lines. The guidance does permit, in certain limited circumstances, a bank to use an alternative operational risk quantification system if there is not sufficient data for the bank to calculate AMA at the required confidence level.

Data Management. The guidance also requires that banks using the AMA have data management and maintenance systems that adequately support all aspects of the AMA, including the other four principal subparts of the guidance described in this article. The guidance provides that, among other things, these systems should be able to: identify and track loss events from initial discovery through final resolution; produce timely internal and public reports, including exception reports for management; and generally support risk management activities.

Verification. Finally, as to Verification, the guidance requires that a bank validate its AMA on an ongoing basis, that the validation be independent of AMA systems development efforts, and that the validation process be subject to an independent review (generally internal and external audit). Based on this review, the bank should annually report to its Board of Directors on the adequacy of its AMA. Among other things, this assessment report should include a review of the accuracy and integrity of the AMA, control elements, and reporting processes. The guidance also requires banks to periodically stress test their quantitative and qualitative models.

The AMA guidance also provides several appendices, providing NPR qualification requirements, risk-weighted AMA assessments, and disclosure requirements, although some of that text was omitted, supervisory standards specific to AMA, AMA information collection templates, and operational loss event types and examples (*e.g.*, retail credit card identity theft is an operational loss issue, whereas other third-party initiated losses generally are treated as credit losses).

➤ FRB Grants Exemption from Section 23A Related to Securities Lending as Principal

The FRB issued an interpretive letter (the “Letter”) responding to Bank of America Corporation’s (“BAC”) request for an exemption from Section 23A of the Federal Reserve Act (“Section 23A”) and the FRB’s Regulation W in connection with BAC’s securities lending program. Under the program, Bank of America, N.A. (“Bank”) would lend, as principal, to Banc of America Securities LLC (“BAS”), securities that have been pledged to Bank as collateral by unaffiliated customers (“Borrowed Securities”). In addition, Bank, as agent for an unaffiliated trust or custody customer, may lend to BAS securities in the customer’s portfolio and indemnify the customer for any losses incurred as a result of a failure by BAS to return the Borrowed Securities. BAS would provide collateral to Bank, whether acting as principal or as agent for a customer, in the form of cash or U.S. government securities, and Bank would ensure that the value of the collateral exceeds, at least slightly, the value of the Borrowed Securities on a daily basis throughout the transaction.

In previous interpretive letters (*e.g.*, Letter dated October 31, 2001, from Jennifer J. Johnson, Secretary of the FRB, to Marjorie Gross, J.P. Morgan Chase & Co.), the FRB found it appropriate to grant exemptions from Section 23A and Regulation W for certain agency securities lending transactions (although such interpretive letters also provided that when a bank, acting as agent, lends customer securities to an affiliate and indemnifies the customer for any failure by the affiliate to return the securities, the bank’s indemnity is a guarantee by the bank on behalf of that affiliate, which is a covered transaction that would generally be subject to such statute and regulation (see the December 4, 2001 *Alert* for additional details)). In the Letter, the FRB found it appropriate, and consistent with this precedent, to also grant an exemption to allow Bank to lend securities, as principal, to BAS (although the FRB similarly determined that when a bank, acting as principal, lends securities to an affiliate, such bank is making a “loan or extension of credit”, and therefore is engaging in a covered transaction that would generally be subject to Section 23A and Regulation W).

The FRB further provided in the Letter that this exemption would apply to any securities lending transactions between Bank and BAS that are secured by property other than cash or U.S. government securities, but only to the extent that the total market value of the securities lent to BAS by Bank (whether acting as principal or indemnifying agent) against such collateral does not in the aggregate exceed the lesser of (i) 5% of Bank’s capital stock and surplus or (ii) 5% of the total market value of the securities lent to BAS by Bank (whether acting as principal or indemnifying agent). Bank would also continue to be subject to the market-terms requirement of Section 23B of the Federal Reserve Act and Regulation W in connection with the proposed securities lending program. In addition, the FRB granted BAC’s request for an exemption from Section 23A and Regulation W for certain short-term, highly collateralized credit extensions by Bank to BAS that are incidental to Bank’s proposed securities lending program. Finally, the FRB granted BAC’s request that “any subsidiary bank of BAC, on the one hand, and any U.S. broker-dealer affiliate of such a bank, on the other hand, may rely on these exemptions on the same terms and conditions as would apply were the transactions between Bank and BAS” (if such subsidiary bank’s securities lending program is structured in substantially the same manner as that of Bank).

➤ DOL Issues Interim Final Rule Regarding Statutory Exemption for Cross-Trading

The Department of Labor (the “DOL”) issued an interim final rule relating to the new statutory exemption for cross-trading under the Employee Retirement Income Security Act of 1974, as amended (“ERISA”). The Pension Protection Act of 2006 added a new Section 408(b)(19) to ERISA, which provides relief for certain cross-trades between large plans. Specifically, the new statutory exemption provides relief for the purchase and sale of a security between a plan and another account managed by the same manager if certain requirements are satisfied. One requirement is that the manager must establish policies and procedures that are fair and equitable to all accounts, including policies and procedures for allocating cross-trades, and must designate an individual responsible for periodically reviewing cross-trades for compliance with such policies and procedures. The interim final rule addresses the content requirements for the written policies and procedures needed to satisfy the

exemption. These requirements include (i) a statement of policy that describes the criteria that will be applied in determining whether a cross-trade will be beneficial to both parties to the transaction, (ii) a description of how the manager will determine that cross-trades are effected at the independent current market price, (iii) a description of the procedures for ensuring compliance with the \$100 million minimum plan size requirement, (iv) a description of how the manager will mitigate any potentially conflicting division of loyalties and responsibilities to the parties involved in the transaction, (v) a requirement that the manager allocate cross-trades in an objective and equitable manner and a description of the allocation methods that will be available to and used by the manager, (vi) the identity and qualifications of the compliance officer responsible for reviewing the manager's compliance, and (vii) a statement describing the scope of the review by the compliance officer. Written comments on the interim final rule should be received by the DOL by, and the interim final rule becomes effective on, April 13, 2007.

➤ **FDIC Proposes Assessment Adjustment Guidelines for Large Banks and Insured Foreign Branches**

In November 2006 the FDIC issued a revised final FDIC insurance premium assessment rule (the "Final Rule"). Under the Final Rule, large (generally over \$10 billion in assets) Risk Category I institutions and insured foreign branches in large Risk Category I (collectively, "Large Banks"), most of whom have not been required in recent years to pay an assessment, would initially be assessed a premium of between 5 and 7 basis points per \$100 of insured deposits annually. (See November 7, 2006 *Alert*.) As part of the implementation of the Final Rule, the FDIC issued proposed guidelines (the "Proposed Guidelines") that the FDIC would use to determine upward or downward adjustments of up to .50 basis points to a Large Bank's assessment rate.

Under the Final Rule, the assessment rates of Large Banks are first determined using either (a) supervisory and long-term debt ratings or (b) supervisory ratings and financial ratios if the Large Bank has no long-term debt ratings. The FDIC says that its resulting assessment rates are largely reflective of the rank ordering of risk of the Large Banks, but the Final Rule allows the FDIC to adjust a Large Bank's assessment rate by up to .50 basis points (after notifying the primary federal regulator of the Large Bank and the Large Bank if the adjustment is adverse to the Large Bank).

There are 10 Proposed Guidelines that the FDIC proposes to use when adjusting assessment rates. The FDIC states that it will: (1) identify inconsistencies between the rank ordering of risk suggested by initial assessment rates and the rank ordering of risk suggested by other risk measures; (2) weight broad-based indicators of a Large Bank's overall risk more heavily than focused indicators and assign a heavy weight to loss severity information that bears on the FDIC's ability to resolve institutions in a cost-effective and timely manner; (3) use focused risk measures and other market indicators to supplement broad-based risk measures; (4) generally, not use a single risk factor to control the decision to make an assessment rate adjustment; (5) when comparing risk information, take into account the normal variations that exist among Large Banks engaged in different lines of business; (6) make an adjustment only if the additional analysis suggests a meaningful risk differential between the Large Bank's initial and adjusted assessment rates; (7) adjust the assessment rate only if the adjustment is well supported and consistent with rates of other Large Banks with similar risk profiles; (8) consult with the Large Bank's primary federal regulator and the appropriate state regulator before making an adjustment or removing a previously implemented adjustment; (9) give Large Banks prior notice of an upward adjustment or removal of a previously implemented downward adjustment; and (10) continually re-evaluate the need for an adjustment.

The FDIC will accept comments on the Proposed Guidelines until March 23, 2007.

Lynne B. Barr
Raymond P. Boulanger
Kay E. Bondehagen
Agnes Bundy Scanlan
Margaret B. Crockett
Eric R. Fischer
Martin J. Flynn
Elizabeth Shea Fries
Jackson B.R. Galloway
Geoffrey R.T. Kenyon
Satish M. Kini
Thomas J. LaFond
Paul W. Lee
Gregory J. Lyons
Robin J. H. Maxwell
William P. Mayer
Philip H. Newman
Anthony R. G. Nolan
Christopher E. Palmer
Regina M. Pisa
Mark S. Raffman
Victoria E. Schonfeld
William E. Stern
Michael P. Whalen
Meryl E. Wiener

To e-mail any of the above attorneys, use first initial of first name followed by last name followed by @goodwinprocter.com. For example, the e-mail address for Gregory J. Lyons would be glyons@goodwinprocter.com

➤ BIS Publishes Home-Host Guidance Relating to Operational Risk Advanced Measurement Approach

The Basel Committee for Banking Supervision (the “Basel Committee”) published guidance (the “Guidance”) on home-host supervisory and allocation mechanisms relating to the operational risk advanced measurement approach (the “AMA”). The Guidance makes clear that it supplements two papers, *Home-host information sharing for effective Basel II implementation* (see June 6, 2006 Alert), or *Principles for the home-host recognition of AMA operational risk capital* (see February 3, 2004 Alert). Comments on the Guidance are due by April 18, 2007.

The Guidance first focuses on home-host supervisory cooperation. As to the scope and frequency, supervisors require sufficient information to enable them to carry out their supervisory duties. Both the home and host supervisors should have information about the intended operational risk approaches of the parent bank and relevant subsidiaries as well as any supervisory assessments of the bank’s AMA. In the case of a hybrid AMA (*i.e.*, where AMA is allocated across the organization, rather than on an entity-by-entity stand alone basis), the host supervisory also must understand the allocation mechanism and related information. As a general matter, so-called supervisory colleges between home and host regulators may be the best way to share information about an organization. The directors and management of a subsidiary must understand the AMA and the capital the institution requires, and parent banks should demonstrate how they information they provide to the home supervisor can help it share information with the host supervisors.

Given its complexity, the Guidance also focuses specifically on home-host information sharing in the event of a hybrid AMA. While not prescribing any particular approach, the Guidance states that any allocation mechanism should conform to the following principles: (1) risk sensitivity (the capital allocated to a subsidiary should reflect its unique risk profile and marginal contribution to the group-wide estimate of operational risk exposure); (2) adequacy of capital (notwithstanding any reliance on a parent’s AMA, the subsidiary’s board and management must ensure that the subsidiary is adequately capitalized given its profile); (3) subsidiary level management support (the allocation mechanism must be understood by the subsidiary’s board and senior management); (4) stability (the allocation mechanism should produce results that are stable and comparable over time); (5) implementation (banks should seek to develop allocation mechanisms that are as simple as possible without sacrificing risk sensitivity); and (6) documentation and review (the allocation mechanism should be clearly documented, and regularly reviewed by internal and/or external audit).