Basel Committee
on Banking Supervision

# Basel III regulatory consistency assessment (Level 2)

# Preliminary report: United States of America

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BANK FOR INTERNATIONAL SETTLEMENTS

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# Contents

# Foreword

This report presents the conclusions of the Basel Committee's Basel III[1] Regulatory Consistency Assessment ("Level 2") for the United States. The assessment detailed in this report has been based primarily on the recently published draft proposals from the US regulatory agencies that implement Basel III in the United States. Considering the draft nature of the US proposal and in accordance with the Committee's agreed procedures for conducting a Level 2 assessment,[2] **this assessment is considered preliminary**. A follow-up assessment will take place once the US agencies have published the final rules that implement Basel III.

The report is based on information available at the time it was completed on 22 August 2012. The assessment was conducted over a six month period from March to August 2012, including the publication of a report in June to the G20 leaders that detailed preliminary findings[3] and an on-site visit in Washington DC also in June. The international assessment team that conducted the review consisted of six experts and was led by Mr Arthur Yuen, Deputy Chief Executive of the Hong Kong Monetary Authority.

For purposes of this Level 2 assessment of the United States, the Office of the Comptroller of the Currency (OCC) served as the assessment team's main counterpart. The OCC, along with representatives from the Federal Reserve System's Board of Governors (FRB) and the Federal Deposit Insurance Corporation (FDIC) (collectively referred to as the "US regulatory agencies" or "US agencies") participated in the meetings that were organised as part of the US review.

Data and information corresponding to the largest internationally active banks operating in the United States have been analysed as part of this report. However, given the tight timeframes and competing priorities for US regulatory agencies to prepare for the proposed rulemaking to meet the Basel III standards, the team did not receive sufficient data to support a comprehensive quantitative assessment within the available time. The assessment team's materiality conclusions are therefore primarily based on qualitative expert judgement augmented by data where applicable. The follow-up assessment should address the data limitations regarding the materiality assessments.

Furthermore, it should be noted that the current assessment excluded certain sections of the Basel III rules that are under review or are being finalised by the Basel Committee. In particular, the leverage ratio, the liquidity ratios and the framework for global systemically important banks (GSIBs) have not been assessed. The US implementation of these rules will be assessed once they are finalised by the Basel Committee.

The report has been written in accordance with "exception-based reporting", ie it focuses on deviations that could lead to a less robust capitalisation of the banking sector than would otherwise have been achieved if the Basel Framework had been implemented in full. As

[1] Basel III builds upon and enhances the regulatory framework set out under Basel II and Basel 2.5 (ie the July 2009 enhancements to Basel II), which now form integral parts of the Basel III framework. The assessments thus cover the full set of components, including those introduced by Basel II and Basel 2.5. This full set of requirements is collectively referred to in this document as "Basel III" or the "Basel framework".

[2] The Committee's Level 2 assessment process is described in the document *Basel III regulatory consistency assessment programme*, available at www.bis.org/publ/bcbs216.htm

[3] The *Report to G20 Leaders on Basel III implementation* is available at www.bis.org/publ/bcbs220.htm

such, areas of compliance are not explicitly addressed, nor are domestic measures that strengthen the minimum requirements. However, with respect to the latter, assessed jurisdictions were given the option to provide this information in an annex to this report (see Annex G). The information on measures to strengthen the minimum requirements has not been assessed nor are they endorsed by the assessment team.

This Level 2 assessment report is part of a comprehensive review programme adopted by the Basel Committee, which comprises the following three levels:

- Level 1: ensuring the timely adoption of Basel III

  The objective of the "Level 1" assessment is to ensure that Basel III is transformed into law or regulation according to the agreed international timelines. It focuses on the domestic rule-making processes and does not include the review of the content of the domestic rules. The Level 1 assessment is the foundation for the assessments at the other levels.

- Level 2: ensuring regulatory consistency with Basel III

  The "Level 2" assessment process assesses the compliance of domestic regulations implementing Basel III with the international minimum requirements defined by the Basel Committee. By identifying domestic regulations and provisions that are not consistent with the rules agreed by the Committee and by assessing their impact on financial stability and on the international level playing field, this process will promote full and consistent implementation of Basel III. It will also facilitate an effective dialogue among members and provide peer pressure if needed. The conclusions following each jurisdiction's assessment will be published by the Committee. This assessment programme supports the Financial Stability Board's monitoring of the implementation of the agreed G20/FSB financial reforms and is fully consistent with the "Coordination Framework for Monitoring the Implementation of Agreed G20/FSB Financial Reforms" put in place by the FSB.[4]

- Level 3: ensuring consistency of risk-weighted assets

  The objective of the "Level 3" assessments is to ensure that the outcomes of the new rules are consistent in practice across banks and jurisdictions. It extends the analysis of Levels 1 and 2, which focus on national rules and regulations, to supervisory implementation at the bank level. This work is currently focusing on the review and validation of how banks calculate their risk weighed assets.

The Level 2 assessment methodology includes the following key elements:

- The Level 2 assessment is factual in nature and focuses on reviewing the completeness (all required Basel III provisions have been adopted) and consistency (differences in substance) of domestic regulations (ie binding documents that effectively implement Basel III independent of their label).
- When a gap or difference is identified, a key driver for assessing compliance is its materiality and impact.
- To the extent possible, the materiality and impact is quantified using all available data, including those submitted by the jurisdiction being assessed. The assessment,

[4] See the "*Coordination Framework for Monitoring the Implementation of Agreed G20/FSB Financial Reforms*" put in place by the FSB at www.financialstabilityboard.org/publications/r_111017.pdf

in particular, seeks to measure the significance of any identified difference(s) for internationally active banks. The assessment considers the current impact and consequences, but also the potential impact of the difference(s) in the future. The assessment team might also perform its own estimations and analyses, using all available sources of information and including in particular the Basel Committee's Quantitative Impact Study (QIS) and Capital Monitoring Group (CMG) data.

- Specificities and drivers of local implementation are not be taken into account when assessing compliance: local specificities are not seen as mitigants for going beyond the scope of national discretion specified within Basel III.
- Domestic measures that strengthen the minimum requirements are not considered to compensate for inconsistencies or gaps identified elsewhere, unless they fully and directly address the identified inconsistencies or gaps.
- The level 2 assessment is limited to regulatory issues and does not consider supervisory or bank practices. The extent to which Basel III is effectively enforced by supervisors or whether firms are actually complying with the Basel III framework is assessed as part of the Level 3 assessment process.

All level 2 assessments are summarised using a four-grade scale:[5] compliant, largely compliant, materially non-compliant and non-compliant:

- *Compliant*: all minimum provisions of the international framework have been satisfied and no material differences have been identified;
- *Largely compliant*: only minor provisions of the international framework have not been satisfied and only differences that have a limited impact on financial stability or the international level playing field have been identified;
- *Materially non-compliant*: key provisions of Basel III have not been satisfied or differences that could materially impact financial stability or the international level playing field have been identified; and
- *Non-compliant: Basel III has not been adopted or differences that could severely* impact financial stability or the international level playing field have been identified.

The assessment team would like to thank the US regulatory agencies for their cooperation and contribution to this exercise and in particular the staff of the OCC who coordinated the work on behalf of the US agencies and hosted the assessment team for the on-site visit.

The assessment team leader also thanks the assessment team members, the agencies contributing these staff and staff from the Basel Committee Secretariat for their valuable contributions.

[5] This four-grade scale is consistent with the approach used for assessing countries' compliance with the Basel Committee's Core Principles for Effective Banking Supervision. The actual definition of the four grades has however been adjusted to take into account the different nature of the two exercises. In addition, components of Basel III that are not relevant to an individual jurisdiction may be assessed as non-applicable.

# Assessment Team

**Team Leader:**

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***Team members:***

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| Mr Sebastijan Hrovatin | European Commission |
| Mr Carlos Luna | National Banking and Securities Commission of Mexico |
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# Executive summary

This report prepared by the Basel Committee's Level 2 assessment team for the United States is based on the US final rule implementing the advanced Basel II approaches,[6] the US final rule on market risk[7] and three notices of proposed rulemaking (NPRs)[8] that were issued by the US regulatory agencies on 7 June 2012. Together with other relevant regulation and regulatory guidance, these documents implement the components of Basel II, Basel 2.5 and Basel III in the United States. See Annex B for a complete overview of the regulations and regulatory documents that the assessment team has taken into consideration for this assessment.

The assessment has benefited from discussions with the US regulatory agencies during the assessment team's on-site visit in Washington DC on 25–29 June 2012. The team also met with representatives from the US banking industry to obtain a broader perspective on the implementation of the Basel framework in the United States.

## Final rules versus proposed rules

The Level 2 assessments focus on the consistency of final or proposed rules with the internationally agreed Basel requirements. Correspondingly, the team's assessment of Basel II, Basel 2.5 and Basel III was based partly on final rules and partly on recently issued proposed rules.

Consistent with the Level 2 assessment process agreed by the Committee, that portion of an assessment that is based on non-final and non-binding documents will be supplemented at a later stage by a follow-up assessment of the final domestic regulation. In this report, assessments based on draft or proposed domestic regulations are distinguished from the assessments based on the final and complete regulations.

The timing for implementing the final rules is covered by the Basel Committee's Level 1 assessment process. The current Level 1 assessment indicates the following status of Basel II, Basel 2.5 and Basel III implementation in the United States:

| Rules | Grade | Next steps – Implementation plans |
|---|---|---|
| Basel II | 4 | Parallel run on-going – All Basel II mandatory institutions are required to implement the advanced approaches to credit risk and operational risk. Banks have made significant progress in |

6 The US final rule "Risk-Based Capital Standards: Advanced Capital Adequacy Framework—Basel II; Final Rule", published in November 2007.

7 The US final rule "Risk-Based Capital Guidelines; Market Risk" published on 7 June 2012.

8 The three US Notices of Proposed Rulemaking on Basel III are: "Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action", "Regulatory Capital Rules: Standardised Approach for Risk-weighted Assets; market Discipline and Disclosure Requirements" and "Regulatory Capital Rules: Advanced Approaches Risk-based Capital Rule; Market Risk Capital Rule", published on 7 June 2012.

| | | |
|---|---|---|
| | | implementation efforts and those institutions in parallel run are reporting both Basel I and Basel II regulatory capital ratios to supervisors on a quarterly basis. US institutions in parallel run remain subject to Basel I capital requirements. |
| Basel 2.5 | 2, 3 | (3) Final market risk capital requirements which incorporate Basel 2.5, as well as restrictions on the use of credit ratings as set forth in the Dodd-Frank regulatory reform legislation approved in June 2012. Market risk requirements are effective as of 1 January 2013.<br>(2) Other Basel 2.5 revisions included as part of the proposed Basel III rule approved in June 2012. The US banking agencies intend to finalise the rule after consideration of public comments. |
| Basel III | 2 | Joint notice of proposed rulemaking approved in June 2012. The US agencies intend to finalise the rule after consideration of public comments. Basel 2.5 and Basel III rulemakings in the United States must be coordinated with applicable work on implementation of the Dodd-Frank regulatory reform legislation. |

1 = draft regulation not published; 2 = draft regulation published; 3 = final rule published; 4 = final rule in force. Green = implementation completed; Yellow = implementation in process; Red = no implementation.

## Compliance assessment

The Level 2 methodology has identified materiality and impact as a key driver for assessing compliance. For identified gaps and differences between Basel and the proposed US rules, therefore, the assessment team has sought to quantify materiality to the extent possible. In addition, the assessment team not only considered current impact and consequences of the differences, but also their potential impact in the future.

In conducting its assessment, the team has considered data, where available, for assessing the materiality of differences between the US proposals and Basel III. However, incomplete data has hampered the quantification process (as explained in the Assessment under *Data for materiality assessment*). In recognition of the limitation, the team refrained from using the data outcomes as the sole driver to determine materiality. Instead, the team used the submitted data in a directional way to supplement the judgement of the team experts. In a number of cases, the team considered the data received as insufficient to finalise the assessment and has listed the issue for the follow-up assessment.

For a number of findings no data was received and in those cases the materiality assessment is fully based on the team's qualitative judgement. The report indicates such instances in which the assessment was based on qualitative rather than quantitative information.

## Assessment findings

### Overall grading

As explained in the Foreword, considering the draft nature of the US proposed rules that implement Basel III, this assessment is considered preliminary and therefore no overall grading has been assigned at this stage. Once the final domestic regulations are published and the follow-up assessment has been carried out, an overall grading will be assigned in line with the Level 2 assessment process agreed by the Basel Committee.

### Sectional gradings

Using a standardised assessment format, the assessment team has provided compliance ratings on 13 key components of the Basel Framework.[9] Information on findings and compliance ratings for each of the 13 elements are described in more detail later in this report.

The assessment team has assessed 12 of the 13 key components as either “Compliant” (C) or “Largely Compliant” (LC). The assessment team has identified as “materially non-compliant” (MNC) the US proposed regulatory treatment of securitisations. The MNC grade for securitisation is mainly due to the US regulatory agencies’ proposed implementation of an alternative approach that would replace the Basel approach, which is based on external credit ratings. The data provided by the US agencies was not sufficient to adequately assess the actual and potential impact of this deviation from the Basel framework. The team has listed this issue for further follow-up analysis.

### Data for the materiality assessment

Overall, the US agencies provided limited quantitative data for the assessment. For example, the team did not receive any specific data measuring the impact of certain findings on the capital ratio of individual banks. As such, directly estimating the impact of certain findings on the capital ratio of US banks was not possible. That said, for a number of items the assessment team received supporting data from the US agencies, for example in the form of aggregated exposure data that allowed for an indirect assessment of the materiality. In addition, for a few banks some specific exposure data was received. The aggregated data was generally based on information from five US banks that represent almost 50% of the US banking industry in terms of total assets.

### Overarching issues

The assessment team has identified a number of overarching issues related to the US implementation of the Basel standards:

#### *Adoption of Basel II, Basel 2.5 and Basel III regulations*

The June 2012 NPRs and market risk final rule form the basis of the US regulatory agencies’ implementation of Basel II, Basel 2.5 and Basel III. The publication of these proposed and final rules reduce the number of gaps previously identified in the interim report to G20 Leaders.[10]

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[9] The component “Operational risk: Basic Indicator Approach and Standardised Approach” has not been assessed, as it is not applicable in the United States.

[10] Basel Committee’s *Report to G20 Leaders on Basel III implementation*, dd. 11 June 2012.

### *Scope of application*

The Basel standards have been designed for "internationally active" banks.[11] However, the term "internationally active" is not specifically defined in the Basel text, leaving its implementation to the discretion of national authorities. In the United States, the agencies require "core banks" (as described below) to adopt the advanced Basel II standards. All other banks in the United States remain subject to the general US risk-based capital rules, which are currently based on Basel I, unless they obtain authorisation to adopt the Basel II advanced approaches. In such cases, these banks are referred to as opt-in banks.[12]

The definition of core banks includes: first, any depository institution (DI) meeting either of the following two criteria: (i) consolidated total assets of USD 250 billion or more; or (ii) consolidated total on-balance sheet foreign exposure of USD 10 billion or more. Second, any US-chartered bank holding company (BHC) meeting any of the following three criteria: (i) consolidated total assets (excluding assets held by an insurance underwriting subsidiary) of USD 250 billion or more; (ii) consolidated total on-balance sheet foreign exposure of USD 10 billion or more; or (iii) having a subsidiary DI that is a core bank or opt-in bank. Finally, any DI that is a subsidiary of a core or opt-in bank is also considered a core bank.

According to information provided by the US regulatory agencies, the banking organisations subject to Basel II standards account for approximately 95% of all the international exposures held by US banking organisations. This is supported by calculations of the assessment team based on public data of US banks that show that approximately USD 1600 billion in foreign assets held by US banks would be subject to Basel II standards, while about USD 20 billion of foreign assets would not be covered (see Annex D). Therefore, the US application of Basel II requirements appears to be in line with the Basel Committee's intended scope of application. In addition, the assessment team notes that any concern about remaining international exposures not covered by the Basel II standards – for example by small banks operating close to the Canadian and Mexican border – will be mitigated to the extent that the recently proposed US standardised approach, which will apply to all US banks, is closer to the corresponding Basel II standards than the current general risk-based capital requirements. The newly proposed US standardised approach would become effective in 2015.

### *US regulatory agencies' selection of Basel II approaches*

As of the preparation of this report, the US agencies have implemented only the advanced approaches of the Basel II framework and none of its standardised approaches. In addition, all banks adopting the advanced approaches are subject to a permanent floor on capital requirements, based on risk-weighted assets calculated according to the general risk-based capital rules. Risk-weighted assets are currently calculated under the general risk-based capital rules which are based on Basel I standards. However, according to the recently-issued NPR on the US standardised approach, risk-weighted assets would be calculated from 1 January 2015 in a way that is more closely aligned to Basel II's Standardised Approach for credit risk.

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[11] Paragraph 20 of Basel II notes that "(the) Framework will be applied on a consolidated basis to internationally active banks." See *Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework - Comprehensive Version* (June 2006) available at www.bis.org/publ/bcbs128.htm.

[12] The US regulatory agencies report that, as of end-2011, there were 17 core banking organisations and one opt-in banking organisation applying the Basel II advanced approaches in the transitional "parallel run" phase, which is described in greater detail below.

The US approach raises the question of what happens when a bank no longer meets the relevant minimum requirements for using its internal models for purposes of calculating regulatory capital (note: these requirements do not relate purely to the performance of the models, but also to other, broader aspects of the governance, risk management and control environment).[13] While the Basel Accord does not require jurisdictions to introduce the standardised approach (just as there is no obligation to introduce the advanced approaches), some jurisdictions understand the rules to imply that, once a bank no longer meets the relevant requirements and therefore ceases to be eligible for using an advanced approach, it should revert to the corresponding Basel II standardised or simplified approach as the alternative for the advanced approach. However, some have argued that the Basel II floor for the advanced approaches suggests that Basel I is the implicit fall-back. The assessment team considers that this issue is important and should be clarified by the Basel Committee.

US regulations do not explicitly define "fall-back approaches" that would apply in case a bank previously authorised to use an advanced approach were to cease to comply with the requirements of that approach. Instead, US regulations would require such a bank to correct the deficiencies and restore compliance, while the supervisor may require the bank to hold additional capital to compensate for the deficiency.[14] In addition, banks using the advanced approaches are subject to the permanent floor mentioned above that is based on risk-weighted assets calculated according to the general risk-based capital rules. The floor would continue to apply after the bank receives regulatory approval to leave the parallel run phase (see below for a description of the parallel run).

The proposed US standardised approach, while still diverging from Basel II in some aspects (discussed in more detail below), would be much closer to Basel II standards in terms of granularity and risk sensitivity than the current general risk-based capital requirements. Quantitative aggregate data provided by the US regulatory agencies suggest that the proposed standardised approach would result in significantly higher risk-weighted assets than the current general risk-based rules (by close to 12% on average for a sample of core banks). However, due to the delayed effective date of the new standardised approach, banks still in parallel run before 2015 would continue to be subject to the US generally risk-based capital rule (based on Basel I standards) in calculating their risk-weighted assets. No data were provided that compare the impact of the proposed US standardised approach with that of the Basel II standardised approach. Moreover, the recently proposed US standardised approach would be less stringent in some areas, such as credit risk mitigation, and would lack a standardised treatment of operational risk. This suggests that the approach may fall short of the Basel II standardised approach.

In the United States, the advanced Basel II approaches are complemented by two other capital requirements in addition to the floor based on the general risk-based capital rules: (i) the non-risk-weighted US leverage ratio; and (ii) the Pillar 2 requirements, including those under the Federal Reserve Board's "capital plan rule". Although these backstops may increase the robustness of US capital requirements vis-à-vis the Basel II approaches, they are not part of the current Basel Pillar 1 framework and do not affect the calculation of risk-weighted assets of US core banks.

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[13] The minimum requirements for entry and on-going use of the Internal Ratings-Based Approach (IRB) are referred to in para 387 of Basel II.

[14] This can be done by requiring the bank to calculate its advanced approaches total risk-weighted assets with any modifications provided by the supervisor.

### *Basel II parallel run*

Banks that wish to adopt the advanced Basel approaches are held to a transitional parallel run period in which they must calculate risk weighted assets under both the advanced and general risk-based capital rule (currently following Basel I). During the parallel run only the risk weighted assets based on the general risk-based capital rule are publicly reported. At the time this report was prepared, none of the core US banks had received permission to exit the transitional parallel run. As a result, all US core banks are still reporting capital ratios based on the general risk-based capital rules, and there is no rule requiring banks to hold more capital as a consequence of higher risk-weighted assets as calculated under the advanced Basel II approaches. In this context, the US regulatory agencies have informed the assessment team that for a number of core banks the amount of risk-weighted assets based on the advanced approaches would in fact be higher (by close to 20% on average) than the amount currently calculated, implying correspondingly higher capital requirements. As mentioned before, the newly proposed US standardised approach, which would generally lead to a higher floor on capital requirements for core banks irrespective of whether they continue in the parallel run or not, will not be in place before 1 January 2015.

Against this background, the assessment team is concerned that the lower risk weighted assets under the Basel I-based general risk-based capital rules than under the advanced Basel II approaches could provide an incentive for some core banks to delay their adoption of the latter and to stay on the parallel run over an indeterminate period. Both the US agencies and the industry representatives indicated in discussions with the assessment team that they did not regard this as a realistic scenario, as investors put pressure on banks to exit the parallel run sooner rather than later. The incentive to stay in the parallel run will be further reduced if the proposed standardised approach is adopted.

The assessment team notes that the Basel rules text does not contain explicit rules regarding the length of the parallel run. Therefore this finding has not been taken into account for the Level 2 grading of the United States.

### *Elimination of references to external credit ratings*

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) mandates the US agencies to remove references to and requirements of reliance on external credit ratings from regulations and to replace them with appropriate alternatives for evaluating creditworthiness. The 7 June NPRs and market risk final rule comply with this requirement. According to an analysis provided by the US agencies, it appears that the alternative approaches proposed/adopted by the US agencies are broadly consistent with the Basel II standards, with the exception of a few areas of possible divergence such as the treatment of eligible financial collateral and certain securitisation positions. While the proposed replacement of credit ratings is not consistent *in form* with Basel II standards, a more substantive concern would be if this approach were to result in lower risk weights than those produced by the use of external credit ratings. Limited data provided by the US agencies suggest that on average the proposed alternative risk-based methodologies produce higher risk weights than the Basel II ratings-based approaches, although in some potentially important cases – in particular under stressed market conditions – the resulting capital charges may fall short.

### *Rules versus guidance*

For the purpose of assessing compliance, the assessment team considered all binding documents that pertain to Basel III implementation. The assessment team discussed with the US agencies the extent to which the preambles and guidance (versus rules) are binding, and the following clarifications were obtained:

- Preambles and guidance do not have the same legal status as a rule, but failure to comply with guidance may lead to a finding of non-compliance and/or can be reflected in supervisory ratings, which in turn can trigger supervisory action. The industry representatives also commented that banks generally regard preambles and guidance as binding. In their experience, regulators also base their supervisory assessments on the requirements set out in such documents. The only areas where they may regard such documents as less binding are “conduct” and “procedural” (as against “prudential”) standards set out in guidance.
- Implementation of Basel standards through rules does not by itself ensure better enforcement than implementation through guidance (Basel is silent on how standards should be implemented). The US agencies have statutory powers to enforce the requirements set out in preambles and guidance through their responsibility for the safety and soundness of the financial institutions under their regulation. Further, the US Prompt Corrective Action (PCA) serves as a statutory ladder of enforcement actions with respect to capital requirements.

Given the above clarifications, the assessment team recommends that the practical effect of the inclusion of certain requirements in the "preambles" should be examined in detail in the Level 3 assessment exercise.

Regarding non-public supervisory examination work programmes, the US agencies noted that, while they do not set binding requirements, they sometimes provide more details on how higher-level principles laid out in regulations, preambles or public guidance are implemented. The assessment team was further informed that the work programmes are often shared with the banks, so that banks know what is expected from them, which should support compliance with the minimum requirements established by the rules.

However, the assessment team has found that, although supervisory work programmes have been shared with the banks, this does not happen on a regular basis nor does it represent an obligatory step from the side of the supervisors. Moreover, since these documents are not made public, they cannot be assessed independently by other interested parties. Also, the assessment team noted that they are generally drafted in relatively procedural terms, mentioning that issues are neither all-inclusive nor necessarily all required to be addressed. Consequently, the team has decided not to incorporate work programmes in its assessment.

### Main specific issues

In addition to the overarching issues, the assessment team has identified a number of specific areas that deviate from the Basel framework. The team regards the following deviations as material or potentially material:

#### *Definition of capital*

The US proposed rules on the definition of capital is largely consistent with Basel III. Nonetheless, the assessment team has identified a difference in the treatment of insurance subsidiaries that may be potentially material and has listed it for further follow-up analysis (see the Detailed findings section below for more in-depth discussion as well as the list of issues for follow-up in Annex F). The Basel rules permit banks to consolidate significant investments in insurance entities as an alternative to the deduction approach on the condition that the method of consolidation results in a minimum capital standard that is at least as conservative as that which would apply under the deduction approach. This treatment has been specified in the Basel III definition of capital Frequently Asked Questions (FAQ).[15] The US capital treatment of insurance subsidiaries of bank holding companies and of savings and loans holding companies is to consolidate an insurance subsidiary's assets and liabilities and deduct its minimum capital requirement. This treatment does not require that it is at least as conservative as the Basel deduction approach and could therefore overstate capital ratios in comparison with those under the full deduction approach. While the US agencies provided data showing that the capital requirements of insurance subsidiaries (ie the capital requirement that is deducted from bank capital under the US approach) are generally not material for the largest ten US bank holding companies, the assessment team believes this issue could become material if a US bank were to acquire a large insurance company.

### *Credit risk standardised approach*

Although the US proposed rules depart from the Basel rules in a number of paragraphs, leaving scope for a potential divergence in the minimum regulatory capital requirements, they are largely consistent with the Basel framework. For example, the US proposed rules assign a fixed 20% risk weight to exposures to Government-Sponsored Entities (GSEs) and to US banks, which corresponds to the lowest risk weight contemplated by Basel II for Public Sector Entities (PSEs) and banks. This approach does not consider the adverse circumstances that may give rise to a substantial downgrade of the GSEs' or the US sovereign credit rating, thus potentially resulting in lower capital charges than provided for under Basel III. That said, the assessment team notes that the current impact of the deviation is not material and that a downgrade of the US sovereign by more than two notches may not be very likely.

Further, with respect to the treatment of credit risk mitigation techniques, Basel stipulates certain minimum ratings for securities to be eligible as financial collateral. The US proposed rules recognise certain securities issued by unrated borrowers or rated lower than the Basel threshold. This implies that US credit risk mitigation may be less robust than that recognised under the Basel rules.

### *Internal ratings-based (IRB) approach for credit risk*

The IRB framework is largely consistent with the Basel framework, although there are some deviations of the US regulation from the Basel text that are relevant and potentially material. These include (i) the definition of qualified revolving retail exposures, which is less strict than the Basel definition; (ii) the absence of a capital requirement for dilution risk for purchased receivables as required by Basel; (iii) a number of minimum requirements for the IRB approach that are implemented through supervisory work programmes, but not in public regulations or guidance; and (iv) the definition of expected credit loss, which deviates from the Basel definition of expected loss (EL) as regards wholesale and retail exposures.

[15] The FAQ was published to make clear the Basel Committee's intention that consolidation should not be allowed to undermine the conservatism of the deduction approach and that the overarching aim must continue to be the removal of the double counting of capital. The Basel III definition of capital FAQs are available at www.bis.org/publ/bcbs211.htm

### *Securitisation*

The US approach for securitisations is judged materially non-compliant with the Basel framework. Pursuant to the Dodd-Frank Act, which prohibits the use of external credit ratings in regulations, the US rules do not include any provision relating to the Basel II securitisation framework's Ratings-Based Approach (RBA). Under the US Simplified Supervisory Formula Approach (US SSFA), the risk weights for securitisation exposures are driven mainly by standardised risk weights and actual delinquency rates of the underlying asset pool. The US agencies calibrated the SSFA to produce risk weights that are generally comparable on a portfolio basis to those under the ratings based approach used in the Basel standardised approach. The limited data provided by the US agencies suggest that the US SSFA can result in risk weights that are significantly higher on average than those calculated under the Basel RBA approach. However, the US SSFA can also result in significantly lower capital requirements for certain downgraded senior securitisation exposures. According to information provided by the US agencies for the 11 banks under parallel run as of end-March 2012, non-trading book securitisation exposures subject to the RBA and trading book securitisation exposures represented, respectively, around 1.6% and 0.5% of total assets. Nevertheless, the relative importance of securitisation exposures could rise in the future. The assessment team believes that more comprehensive data and further analysis is required to assess the actual and potential materiality of the deviations from the Basel framework and has listed the treatment of securitisation as an issue for the follow-up assessment (see Annex F). The US agencies have reported that they are conducting a quantitative analysis comparing the new proposed approaches with the Basel approaches over time.

### *Counterparty credit risk*

The US definition of "specific wrong-way risk" is narrower than the one adopted in Basel III. This could potentially lead to an underestimation of the counterparty risks associated with, for example, certain derivative positions.

### *Operational risk advanced approach*

The US approach deviates in a number of areas from the Basel operational risk standards, for example, regarding certain requirements for the choice of risk factors for operational risk measurement. This could potentially lead to a less robust operational risk measurement framework for US banks.

# Overview table of compliance grading

| Key components of the Basel framework | Grade |
|---|---|
| **Overall Grade:** | Not yet assigned given preliminary nature of findings |
| **Capital requirements** | |
| Scope of application | C |
| Transitional arrangements | (C) |
| Definition of capital | (LC) |
| **Pillar 1: Minimum capital requirements** | |
| Credit Risk: Standardised Approach | (LC) |
| Credit risk: Internal Ratings-Based approach | (LC) |
| Credit risk: securitisation framework | (MNC) |
| Counterparty credit risk rules | (LC) |
| Market risk: standardised measurement method | C |
| Market risk: internal models approach | C |
| Operational risk: Basic Indicator Approach and Standardised Approach | N/A |
| Operational risk: advanced measurement approaches | LC |
| Capital buffers (conservation and countercyclical) | (C) |
| G-SIB additional loss absorbency requirements | (1) |
| **Pillar 2: Supervisory Review Process** | |
| Legal and regulatory framework for the Supervisory Review Process and for taking supervisory actions | C |
| **Pillar 3: Market Discipline** | |
| Disclosure requirements | (C) |
| **Liquidity standards** | |
| Scope of application | (1) |
| Liquidity Coverage Ratio | (1) |
| Net Stable Funding Ratio | (1) |
| **Leverage ratio** | |
| Leverage ratio | (1) |

Compliance assessment scale: C (compliant), LC (largely compliant), MNC (materially non-compliant) and NC (non-compliant). Definitions of the compliance scale are found in the Foreword of this document. Ratings that are based on draft or proposed rules are indicated within parentheses. Ratings based on final rules are indicated without parentheses. (1) To be assessed after the Committee concludes its review on any revisions or final adjustments of these elements of Basel III.

# Response from the US agencies

The US banking agencies welcome the opportunity to respond to the Basel Committee on the report on the U.S. implementation of the Basel framework.

Although the report sometimes seems somewhat negative in tone, on the majority of issues we find it to be substantively both fair and accurate. We thank the assessment team for their conscientious and thorough analysis.

We concur with each of the ratings of compliant and largely compliant, which means that, in the view of the assessment team, all provisions of the Basel framework have been satisfied in the case of compliant ratings, or only minor provisions have not been satisfied and there are no differences that could materially impact financial stability or the international level playing field in the case of largely compliant ratings.

In just one area – the area of securitisation – the assessment team has rated the US agencies as materially non-compliant. This area was affected by the decision made in the US Congress to remove credit ratings from US bank regulation during the passage of the Dodd-Frank Act in 2010, resulting in a formal deviation from the letter of the Basel standards. These standards require the use of ratings whenever they are available for setting capital charges for securitisation exposures and US law does not allow the US agencies to do this. However, the evidence we have presented during this assessment and other work conducted by the Basel Committee suggests that the impact, if any, on the overall capital requirements for US banks will not be material. Indeed, the report refers to the data provided by the US agencies suggesting that "... the US SSFA can result in risk weights that are significantly higher on average than those calculated under the Basel RBA approach." While we acknowledge that more data is needed to be categorical about this and that we do deviate from the letter of Basel and therefore are not completely compliant, we believe that the US implementation is likely to be robust by the standards of the Basel Committee. As a result we believe that we are largely compliant rather than materially non-complaint.

For future Level 2 assessments wherever the Basel Committee undertakes them, it would help the teams and the reviewed jurisdictions if the Committee could define materiality more precisely. A considerable amount of work is involved in conducting a thorough assessment and resources could be deployed more effectively if they were focused early on in areas where differences might really matter. We hope this issue can be addressed during the "lessons learned" exercise that the Committee plans for year end.

The assessment programme is an important innovation in the way the Basel Committee has worked since the 2008 banking crisis. We recognise that sometimes countries cannot implement Basel Committee standards to the letter, but all members of the Committee should try their hardest to do so and, when they cannot, they should be clear about the reasons why. Assessments promote the level playing field through transparency. Moreover, they can surface areas where there is scope for improvement in national regulations. The US agencies support the assessment program and we look forward to working with the other Committee members to help it reach its full potential in the years ahead.

# Assessment

## 1. Introduction

### Overview of the US banking sector

The US banking sector represents a relatively small part of the US financial system. The share of banking assets in total assets of the financial sector is approximately 26% (see the Table in Annex D). In terms of national GDP, the banking sector measures approximately 84%.

There are more than 6,000 depository institutions that fall under the FDIC deposit insurance scheme. The sector is, however, highly concentrated:

- There are eight US banks that have been designated global systemically important. Together these banks hold more than 50% of all the assets of the US banking sector.
- There are 17 "core" US banks, ie banks that exceed the threshold of USD 250 bn in total assets or USD 10 bn in foreign exposures. These banks are required to implement the Basel II advanced approaches. In addition there is 1 opt-in bank that elected to adopt the Basel II advanced approaches. At the time of this assessment all banks are still in parallel run and no bank has received permission to base their capital requirements on the advanced Basel II approaches.
- Approximately twenty or so other US banks have international exposures, the size typically being very small. The total amount of foreign assets not covered by Basel II would be approximately USD 20 bn.

In March 2012, the weighted average total risk-based ratio of all US banks was 15.3% (see Figure 1 in Annex D). The Tier 1 risk-based ratio was 12.9%. For the five largest US banks, the average total risk-based capital ratio was 17.1% and the Tier 1 risk-based ratio 13.8%. These ratios are based on the general risk-based capital rule, which is the US adoption of Basel I.

### Broader context of the Level 2 assessment

The regulatory consistency assessment (Level 2) for the United States is part of the Financial Stability Board's (FSB) mandate of monitoring the implementation of the agreed G20/FSB financial reforms.[16] The level 2 assessment seeks to assess regulatory consistency with Basel II/III. Specifically, the level 2 process is meant to

(i) identify the domestic regulations and provisions that are, in terms of content (ie scope and substance) not compliant with the rules agreed by the Basel Committee; and

(ii) assess the potential materiality of the deviations and impact on financial stability and the international level playing field.

[16] See the "*Coordination Framework for Monitoring the Implementation of Agreed G20/FSB Financial Reforms*" put in place by the FSB.

It should also be noted that the Basel Committee's implementation assessment programme complements the Financial Sector Assessment Program (FSAP),[17] which is conducted by the International Monetary Fund and the World Bank. In particular, the Basel implementation assessment provides a comprehensive examination of regulatory consistency with the agreed Basel framework, while the FSAP considers the full range of the regulatory framework and supervisory practices.

### Documents used for the assessment

The Level 2 assessments are benchmarked against Basel II, 2.5 and Basel III rules. Some Basel III rules were left out because they are still in the process of being completed by the Basel Committee. This applies for the framework for global systemically important banks (G-SIBs), the liquidity requirements and the leverage ratio.[18] For a complete list of Basel documents that are included in the assessment, see Annex B.

Regarding the US documents, the assessment is based on published final rules and the latest proposed rules as published by the US regulatory agencies on 7 June 2012. In addition, the assessment takes into account the preambles to the rules and supervisory guidelines issued by the US agencies. See, for an overview of the US documents that have been consulted, Annex B.

Further, the US agencies have completed a self-assessment questionnaire on the Basel implementation which was reviewed by the team. The US agencies have provided additional follow-up information requested by the assessment team.

### Data for the materiality assessment

Overall, the US agencies provided limited quantitative data for the assessment. For example, the team did not receive any specific data measuring the impact of certain findings on the capital ratio of individual banks. As such, directly estimating the impact of certain findings on the capital ratio of US banks was not possible. That said, for a number of items the assessment team received supporting data from the US agencies, for example in the form of aggregated exposure data that allowed for an indirect assessment of the materiality. In addition, for a few banks some specific exposure data was received. The aggregated data was generally based on information from five US banks that represent almost 50% of the US banking industry in terms of total assets.

### On-site visit

From 25 June through 29 June, the assessment team held an on-site visit at the premises of the Office of the Comptroller of the Currency (OCC) in Washington DC. The team met with several representatives of the US agencies, including the OCC, the Federal Reserve Board (FRB) and the Federal Deposit Insurance Corporation (FDIC). In addition, the assessment team met with representatives of the American Bankers Association (ABA) and the Financial Services Roundtable (FSR).

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[17] The FSAP assesses country's compliance with the Basel Committee's Core Principles for Effective Banking Supervision (BCPs).

[18] See www.bis.org/publ/bcbs216.pdf, p.8, for an overview.

## 2. Detailed findings

In the next sections, the detailed assessment findings are presented together with an assessment of their materiality. The sections correspond with the sections in the overview table on page 13.

As remarked in the foreword, only deviations that cause or may cause a less robust capitalisation of the banking sector are reported. Areas of compliance are not explicitly addressed, nor are areas where the US approach would be more stringent than the Basel standards. Areas where the domestic rules strengthen the minimum requirements have not been taken into account in the section gradings.

The following findings are not in order of importance, but in the order of assessment through the relevant Basel rules texts.

### 2.1 Scope of application

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| **Section Grading** | C |
| **Summary** | The scope of the US implementation of Basel is compliant. |
| **Overview of findings by Basel II paragraph(s):** | |
| Basel paragraph(s) | |
| Reference in the domestic regulation | |
| Findings | The Basel framework applies to all "internationally active" banks. The US regulatory agencies require the implementation of the advanced Basel standards for all "core banks".<br><br>The definition of core banks includes: first, any depository institution (DI) meeting either of the following two criteria: (i) consolidated total assets of USD 250 billion or more; or (ii) consolidated total on-balance sheet foreign exposure of 10 billion or more. Second, any US-chartered bank holding company (BHC) meeting any of the following three criteria: (i) consolidated total assets (excluding assets held by an insurance underwriting subsidiary) of USD 250 billion or more; (ii) consolidated total on-balance sheet foreign exposure of USD 10 billion or more; or (iii) having a subsidiary DI that is a core bank or opt-in bank. Finally, any DI that is a subsidiary of a core or opt-in bank is also a core bank.<br><br>Data analysis shows that this definition covers more than 95% of all foreign exposures held by US banks. See also Figure 2 in Annex D. |
| Materiality | The assessment team judges the finding as not material. |

### 2.2 Transitional arrangements

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| **Section Grading** | (C) |
| **Summary** | The US approach for the capital floor differs from the Basel approach. However, the assessment team judges that the approach will generally be more conservative than the Basel approach. |
| **Overview of findings by Basel II paragraph(s):** | |

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| Basel paragraph(s) | 45-49: Transitional arrangements (amended by BIS press release 13 July 2009) |
| Reference in the domestic regulation | Basel III NPR: Section 300 |
| Findings | Basel stipulates that IRB banks calculate a floor based on the minimum capital requirement under Basel I, including certain adjustments for capital deductions and add-ons, and multiply that number by 80% (the level of the floor). The resulting number is compared with the minimum capital requirement under the advanced approach (again including certain capital deductions and add-ons), and the difference between the two numbers must be added back into the RWA calculation for the advanced Basel approach.<br><br>The proposed US calculation of the floor for the total capital ratio differs mathematically from the Basel calculation. The US approach involves calculating two capital ratios: one based on the proposed US standardised approach (to be effective January 2015) and one based on the US advanced approach (including certain adjustments to the total capital numerator). US banks should then report the lower of the two ratios.<br><br>Although it cannot be ruled out that for certain balance sheet configurations the US approach may be less conservative, the assessment team finds that the US approach will generally be more conservative than the Basel approach, as the US floor is 100% of the US standardised approach, while the Basel floor is 80% of Basel I approach. The US approach may only be less conservative for certain extreme and implausible scenarios. |
| Materiality | The assessment team judges the finding as not material, given that the US floor will be generally more conservative than the Basel floor. |

## 2.3 Definition of capital

| **Section Grading** | (LC) |
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| **Summary** | Although the US rules depart from Basel rules text in some of areas, the implementation of Basel III can be considered as largely compliant:<br><br>The US capital treatment of insurance subsidiaries of bank holding companies and of savings and loans holding companies differs from Basel III and could lead to a potential overstatement of capital ratios.<br><br>The US rules allow under circumstances a greater recognition of minority interest, which could result in an overstatement of capital ratios. This finding can be judged as potentially material, the impact depending on the size of the countercyclical buffer that would apply to a consolidated subsidiary of the bank.<br><br>For non-common equity Tier 1 and Tier 2 capital instruments issued by US-based banks and bank holding companies, the US laws and regulations can be considered as consistent with the option of statutory implementation of Basel III PON loss absorbency standards. However, statutory implementation of PON loss absorbency cannot be applied to such instruments when they are issued by non-US subsidiaries of US-domiciled internationally active banks or bank holding companies to the extent that the necessary legal provisions do not have cross-border reach. No provisions have been issued or proposed to the effect that (i) such instruments would cease to qualify for recognition at the group's |

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| | consolidated level, unless PON loss absorbency is implemented contractually in compliance with the Basel PON standards, and (ii) therefore need to be phased out in accordance with Basel III transitional arrangements for non-qualifying capital instruments. |
| **Overview of findings by Basel III paragraph(s):** | |
| Basel paragraph(s) | 30-34: IV. Insurance entities |
| Reference in the domestic regulation | Section IV; 72 FR 69288, 69324; Section Part 225 Section 11; 72 FR 69288, 69431; Table 11.1; 72 FR 69288, 69432. Not reformed in Basel III NPR. |
| Findings | Basel permits banks to consolidate significant investments in insurance entities as an alternative to the deduction approach on the condition that the method of consolidation results in a minimum capital standard that is at least as conservative as that which would apply under the deduction approach.<br><br>The US capital treatment of insurance subsidiaries (consolidation of insurance subsidiary's assets and liabilities and deduction of its minimum capital requirement, which is typically 200 per cent of the subsidiary's Authorised Control Level as established by the appropriate state regulator of the insurance company) does not require that it is at least as conservative as the Basel deduction approach and could therefore result in a potential overstatement of bank capital ratios. |
| Materiality | The US agencies have provided data that show that the capital requirements of insurance subsidiaries (ie the capital requirement that is deducted from bank capital under the US approach) are generally not material for the largest ten US banks. Four of these banks reported that the current minimum regulatory capital held for the insurance subsidiaries was less than 0.1% of Tier 1 capital while for two of them it was less than 0.5% of Tier 1 capital. However, the issue could become potentially material once a US bank would take over a large insurance company. The assessment team therefore judges the issue as potentially material and has listed it for further follow-up analysis (see Annex F). |
| Basel paragraph(s) | 52-53: Common Equity Tier 1<br><br>54-56: Additional Tier 1 Capital<br><br>57-59: Tier 2 Capital |
| Reference in the domestic regulation | Basel III NPR: Section 20(b)(c)(d) and (e)(1) |
| Findings | Basel rules contain very specific eligibility criteria for regulatory capital instruments and do not allow for supervisory discretion. Paragraph 20(e)(1) in the US NPR contains the following discretion: "Notwithstanding the criteria for regulatory capital instruments set forth in this section, the [AGENCY] may find that a capital element may be included in a [BANK]'s common equity tier 1 capital, additional tier 1 capital, or tier 2 capital on a permanent or temporary basis."<br><br>There is no condition specified in the legislation for exercising the discretion (eg defining emergency situations), and as such there is no legal basis that would prohibit the US agencies from exercising the discretion.<br><br>The US agencies have explained that the above discretion is an example of Reservation of Authority, which is a common feature of US regulations to allow the agencies to react on a case by case basis to unforeseen circumstances, including emergencies or requirements in newly enacted Federal laws. As reported by the US agencies, the |

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| | banking agencies do not often exercise their reservations of authority, and when they do, they generally follow transparent procedures and publish their decisions. US administrative law generally requires agency action to be neither arbitrary nor capricious, which in turn requires that an agency's actions be transparent and supportable by evidence in the public record.<br><br>Paragraph 20(e) of the US Basel III NPR includes the following constraints on the use of the discretion:<br><br>• A bank must receive prior approval from the corresponding federal banking agency before including a capital element in its capital, unless it corresponds to an element previously approved in a decision made publicly available.<br><br>• A federal banking agency must consult with the other federal banking agencies before approving a capital element.<br><br>• The decision approving a capital element must be made public, stating the reasons for the decision and describing the material terms of the capital instrument involved. |
| Materiality | Currently the finding is not material. If the US agencies only exercise the discretion as they have explained, the finding is unlikely to be material. The Basel Committee would need to re-assess the materiality of the impact as and when this discretion is exercised by the US agencies and publicised as required by the regulations. |
| Basel paragraph(s) | 54-56: Additional Tier 1 Capital |
| Reference in the domestic regulation | Basel III NPR: Section 20(c) and (e)(1) |
| Findings | Some instruments issued under the Small Business Jobs Act (SBJA) of 2010 and under the Emergency Economic Stabilization Act of 2008 will continue to be recognised as Tier 1 capital for an indefinite period, regardless of their compliance with the Basel Tier 1 definition. According to US agencies, instruments under SBJA are only issued by small (non-internationally active) banks. |
| Materiality | Based on qualitative considerations, the assessment team judges the finding as not material. |
| Basel paragraph(s) | 57-59: Tier 2 Capital |
| Reference in the domestic regulation | Basel III NPR: Section 20(d) and (e)(1) |
| Findings | The Basel III criterion 4.c stipulates that as one of the conditions to be eligible for Tier 2 capital, there are no step-ups or other incentives to redeem. The US NPR qualifies this criterion by stating that the instrument must not have any terms or features that require or create "significant" incentives for the bank to redeem the instrument prior to maturity. According to the US agencies, the word "significant" is added in the text as the US agencies believe that there is an incentive for banks to early redeem when an instrument's maturity is less than 5 years. Instruments with step-up are not eligible in the US. |
| Materiality | Based on qualitative considerations, the assessment team judges the finding as not material. |
| Basel paragraph(s) | 62: Minority interest – Common shares issued by consolidated subs.<br><br>63: Tier 1 capital issued by consolidated subsidiaries<br><br>64-65: Tier 1 and Tier 2 capital issued by consolidated subsidiaries |
| Reference in the | Basel III NPR: Section 2 – definition of "common equity tier 1 minority |

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| domestic regulation | interest"; Section 20(b)(4); and Section 21(a)<br><br>Basel III NPR: Section 2 – definition of "tier 1 minority interest"; Section 20(c)(2); and Section 21(b)<br><br>Basel III NPR: Section 2 – definition of "total capital minority interest"; Section 20(c)(2); and Section 21(c) |
| Findings | The Basel adjustments for minority interest are based on the minimum capital requirements plus the capital conservation buffer, with the latter understood as excluding the countercyclical buffer.<br><br>The US Basel III NPR includes a countercyclical capital buffer (if the buffer is applied) in the base capital ratio. This would imply that the amount of minority interest that could be included in the parent bank's Common Equity Tier 1, Tier 1 and Total Capital would be larger than under Basel III. |
| Materiality | The materiality has not been assessed quantitatively due to lack of data. Based on qualitative considerations, the assessment team judges the finding as potentially material, the impact depending on the size of countercyclical capital buffer that would apply to a consolidated subsidiary of the bank after its implementation. |
| Basel paragraph(s) | 94(f)-(g): Transitional arrangements – Existing capital instruments |
| Reference in the domestic regulation | Basel III NPR: Section 20(c)(3) and (d)(4); Section 300(d)(1), (2) and (3) |
| Findings | Under Basel III, existing public sector capital injections will be grandfathered until 1 January 2018. The recent public sector capital injections in the US (that were issued under the Small Business Jobs Act of 2010 or, prior to October 4, 2010, under the Emergency Economic Stabilization Act of 2008) would be grandfathered permanently and be allowed to be included in additional Tier 1 capital regardless of compliance with qualifying criteria for common equity Tier 1 or additional Tier 1 capital instruments. |
| Materiality | Based on qualitative considerations, the assessment team judges the finding as not material. |
| Basel paragraph(s) | BIS press release 13 January 2011 |
| Reference in the domestic regulation | Basel III NPR, Text of Common Rule, See Annex E for a comprehensive assessment of PON including references to domestic US laws and regulations. |
| Findings | According the Basel III PON standards, instruments issued on or after 1 January 2013 must meet the criteria set out in paragraphs 1 through 7 to be included in regulatory capital. Instruments issued prior to 1 January 2013 that do not meet the criteria set out above, but that meet all of the entry criteria for Additional Tier 1 or Tier 2 capital set out in Basel III: A global regulatory framework for more resilient banks and banking systems, will be considered as an "instrument that no longer qualifies as Additional Tier 1 or Tier 2" and will be phased out from 1 January 2013 according to para 94(g).<br><br>Assessment:<br><br>The US laws and regulations can be considered as consistent with all the seven paragraphs the Basel III PON standards if the triggers are implemented under receivership. Moreover, under US law, any capital injection to banks outside of receivership would require congressional approval.<br><br>However, to the extent that the US framework cannot be enforced outside of the United States, non-common equity Tier 1 and Tier 2 |

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| | instruments issued by non-US subsidiaries of a US-based banking group could not be recognised as regulatory capital at the group's consolidated level unless PON loss absorbency is implemented contractually in compliance with the Basel PON standards.<br><br>No provisions have been issued or proposed to the effect that (i) such instruments would cease to qualify for recognition at the group's consolidated level unless PON loss absorbency is implemented contractually in compliance with the Basel PON standards and (ii) they would therefore need to be phased out according to the Basel III schedule applicable to all instruments that no longer qualify as Additional Tier 1 or Tier 2. |
| Materiality | To the extent that non-common equity Tier 1 and Tier 2 instruments issued by non-US subsidiaries of US banks or bank holding companies currently represent a significant fraction of regulatory capital of US-based internationally active banks or banking groups, a material difference could arise if the United States do not have transitional arrangements in place for the phasing out of such instruments in accordance with Basel III transitional arrangements for instruments that no longer qualify as Additional Tier 1 or Tier 2.<br><br>The finding is potentially material. The item has been listed for the follow-up assessment (Annex F). |

## 2.4 Pillar 1: minimum capital requirements

### *2.4.1 Credit risk: standardised approach*

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| **Section Grading** | (LC) |
| **Summary** | The US proposed rules depart from Basel III in a number of paragraphs. Although in the US core banks are subject to the advanced approaches, the standardised approach is proposed to be used for calculating the floors on capital requirements for such banks, as well as in determining actual capital requirements for core banks still in parallel run. The proposed approach leaves scope for a potential divergence from Basel in the resulting capital requirements – especially in case of adverse circumstances that would give rise to substantial downgrading of the US government and of the borrowers. However, most findings are currently considered as non-material, with reservations related to the treatment of credit risk mitigation techniques. |
| **Overview of findings by Basel II paragraph(s):** | |
| Basel paragraph(s) | 53-56 Claims on sovereigns |
| Reference in the domestic regulation | Standardized Approach NPR: Section 32 (a) (1) |
| Findings | Basel permits a 0% risk weight for sovereign exposures only under certain conditions, including a certain minimum credit score from Export Credit Agencies (ECA) or a denomination and funding in the domestic currency of the sovereign.<br><br>The risk-weighting of exposures to the US government, its central bank, or a US government agency is set at 0% irrespective of the United States' ECA risk score or the denomination and funding of the claims. However, the treatment can be seen as currently equivalent to Basel II, short of being fully consistent, based on the following considerations: |

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| | Currently, the United States has the highest possible ECA score;<br>The likelihood of the United States being downgraded by two notches seems very low (the OECD methodology assigns the highest country risk score to all High Income OECD countries as defined on an annual basis by the World Bank; this currently means countries with a per capita gross national income (GNI) above USD 12,476; the US has a per capita GNI of USD 48,450); and<br>Hardly any US sovereign debt is denominated or funded in a currency other than the US dollar. |
| Materiality | The assessment team judges the finding as not material. |
| Basel paragraph(s) | 57-58: Claims on non-central government public sector entities (PSEs) |
| Reference in the domestic regulation | Standardized Approach NPR: Section 32(c) and (e) |
| Findings | The Basel treatment of exposures to public sector entities (PSEs) is risk sensitive as it derives the risk weight from either the external credit rating of the PSE or from the credit score of the relevant sovereign.<br>The US agencies assign a fixed 20% risk weight to exposures to American PSEs (including the US government sponsored enterprises, GSEs, which the team found consistent with the definition of PSEs in para 57 of Basel II) irrespective of the external credit assessment of the entity itself or of the US sovereign, thus potentially resulting in lower capital charges than provided for under Basel II.<br>Although the treatment can be seen as not fully consistent to Basel II, the deviation is currently not material. Also, the likelihood of a substantial downgrade of the US government (more than two notches) that would result in a higher risk weight for GSEs under Basel II standards seems small. |
| Materiality | The assessment team judges the finding as not material. |
| Basel paragraph(s) | 59: Claims on multilateral development banks (MDBs) |
| Reference in the domestic regulation | Standardized Approach NPR: Section 32(b) |
| Findings | Basel permits a 0% risk weight for exposures to MDBs that qualify with respect to certain criteria.<br>The US definition of MDB slightly differs from that of Basel II: the US NPR draws a limitative list of MDBs that is consistent with the Basel Committee's list of MDBs currently eligible for a 0% risk weight but adds "any other multilateral lending institution or regional development bank in which the U.S. government is a shareholder or contributing member or which the [AGENCY] determines poses comparable credit risk." |
| Materiality | Based on qualitative considerations, the assessment team judges the finding as not material. |
| Basel paragraph(s) | 60-64 Claims on banks |
| Reference in the domestic regulation | Standardized Approach NPR: Section 32(d)(1) |
| Findings | The Basel treatment of exposures to banks is risk sensitive as it derives the risk weight from either the external credit rating of the bank or from the credit score of the country in which the bank is incorporated.<br>The risk-weighting of exposures to US banks is set at 20% (ie |

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| | equivalent to one notch higher than the proposed risk weight for exposures to the US sovereign), irrespective of the United States' ECA risk score, the bank's external credit assessment, or the currency in which the exposures are denominated or funded.<br><br>However, the treatment can be seen as currently equivalent to Basel, short of being fully consistent, as the United States currently has the highest country risk score. Also, the likelihood of a substantial downgrade of the US government (more than two notches) that would result in a higher risk weight for banks under Basel II standards seems small. |
| Materiality | The team judges the finding as not material. |
| Basel paragraph(s) | 82-89: Off-balance sheet items |
| Reference in the domestic regulation | Standardized Approach NPR: Section 33 |
| Findings | Basel permits a 0% credit conversion factor to exposures that are unconditionally cancellable at any time and without prior notice.<br><br>The US conditions for a 0% CCF are less stringent than those required by para 83 of Basel II: the unconditional cancellable condition is not required to be "at any time and without prior notice" as required under Basel II. According to the US agencies this follows from US consumer protection laws, which require short notice periods. This is consistent within the scope of footnote 33 of Basel II. |
| Materiality | Based on qualitative considerations, the assessment team judges the finding as not material. |
| Basel paragraph(s) | 109-118 amended by BIII: Overarching issues |
| Reference in the domestic regulation | Sections 32-33; 72 FR 69412-69417 |
| Findings | Basel sets out criteria that banks must fulfil in order to comply with the requirements for credit risk mitigation.<br><br>In the US some of these criteria are not implemented by regulation:<br><br>1. The consideration of procedures for collateral management, operational procedures, legal certainty and risk management processes for the recognition of financial collateral is spelled out in the Preamble of the Standardized Approach NPR, however not in a prescriptive way.<br><br>2. The requirement set by para 115(i) of Basel III (whereby banks must devote sufficient resources to the orderly operation of margin agreements with OTC derivative and securities-financing counterparties, and have collateral management policies to control, monitor and report the risk to which margin agreements expose them, the concentration risk to particular types of collateral, the reuse of collateral and the surrender of rights on collateral posted to counterparties) are not found in any US rule or guidance, but in the Agencies' examination manuals (publicly available). |
| Materiality | Based on qualitative considerations, the assessment team judges the finding as not material. |
| Basel paragraph(s) | 119-144: Overview of Credit risk Mitigation (CRM) techniques |
| Reference in the domestic regulation | Standardized Approach NPR: Sections 32-33 |

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| | 72 FR 69412-69417 |
| Findings | Basel recognises financial collateral under certain conditions. A key provision is the absence of a material positive correlation between the credit quality of the counterparty and the collateral value.<br><br>Regarding the implementation in the US no regulation has been found to reflect of the requirement of absence of material positive correlation between the credit quality of the counterparty and collateral value as a prerequisite for collateral recognition. The Preamble of the NPR only expects that the correlation between risk of the underlying direct exposure and collateral risk in the transaction be considered.<br><br>Further, the consideration of procedures for timely liquidation (para 125 of Basel II) and segregation of collateral by custodians (para 126 of Basel II) are spelled out in the Preamble of the Standardized Approach NPR, however not in a prescriptive way. |
| Materiality | Based on qualitative considerations, the assessment team judges the finding as not material. |
| Basel paragraph(s) | 145-146: Collateral – Eligible financial collateral |
| Reference in the domestic regulation | Standardized Approach NPR: Sections 2, 32-33<br><br>72 FR 69401, FR 69412-69417 |
| Findings | Basel stipulates that financial collateral (not being sovereign paper) should have a minimum rating of BBB- or equivalent as determined by a recognised statistical rating organisation or be unrated bank securities satisfying the requirements set out in Basel II para 145-146.<br><br>The US Standardized Approach NPR excludes non-investment grade securities (according to the "investment grade methodology" used for specific market risk). However, this approach would allow as eligible collateral a security that would be considered as investment grade by a banking organisation, without explicitly excluding the possibility that it is an unrated security issued by a nonbank firm, or a non-eligible unrated bank security or rated below BBB-.<br><br>Moreover, in contrast with Basel, the US Standardized Approach NPR does not require that the money market mutual fund shares and other mutual fund shares be limited to investing in eligible instruments (within the meaning of para 146 of Basel II) to be considered as eligible collateral. |
| Materiality | With respect to the investment grade methodology, the materiality could not be assessed quantitatively. Based on qualitative considerations, the assessment team judges the finding as potentially material. The US approach would leave open the possibility for US banks to use certain collateral that does not meet the Basel requirements. The issue has also been listed for follow-up analysis (see Annex F).<br><br>With respect to mutual fund shares, the information received from the US agencies suggests that money market mutual fund shares play only a limited role as financial collateral and that therefore the materiality is low. However, the assessment team judges the finding as potentially material as it cannot be ruled out that US banks will increase the usage of money market mutual fund shares as collateral that do not meet the Basel requirements. |
| Basel paragraph(s) | 147-155: Collateral – The comprehensive approach (amended by BIII) |
| Reference in the domestic regulation | Standardized Approach NPR: Sections 32-33<br><br>72 FR 69412-69417 |

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| Findings | Given the findings on Basel II paras 145-146, the potential recognition of collateral that would not be eligible under Basel standards could result in too low exposure amounts after risk mitigation when applying the comprehensive approach. |
| Materiality | The materiality could not be assessed quantitatively. Based on qualitative considerations, the assessment team judges the finding as potentially material. |
| Basel paragraph(s) | 156-165: Collateral – The comprehensive approach (cont.) |
| Reference in the domestic regulation | Standardized Approach NPR: Sections 32-33<br>72 FR 69412-69417 |
| Findings | Basel II para 162 requires banks to use the estimated volatility data and holding period that support their own estimates of haircuts in their day-to-day risk management processes.<br>No such provisions have been found in the US regulations. |
| Materiality | Based on qualitative considerations, the assessment team judges the finding as not material. |
| Basel paragraph(s) | 188: On-balance sheet netting |
| Reference in the domestic regulation | Standardized Approach NPR: Sections 32-33<br>72 FR 69412-69417<br>Agencies' Counterparty Credit Risk Management Guidance |
| Findings | Basel allows on-balance sheet netting of assets and liabilities under strict conditions, including the monitoring of roll-of risks and the monitoring and controlling of the relevant exposures on a net basis.<br>In the US on-balance sheet netting of assets and liabilities and deposits is recognised by US GAAP. However the above requirements are embedded in supervisory guidance and not in supervisory regulations or, for that matter, US GAAP. |
| Materiality | Based on qualitative considerations, the assessment team judges the finding as not material. |
| Basel paragraph(s) | 189-201: Guarantees and credit derivatives (amended by BIII) |
| Reference in the domestic regulation | Standardized Approach NPR: Sections 2, 32-33<br>72 FR 69399-69400, FR 69412-69417 |
| Findings | Basel stipulates a range of eligible guarantors (protection providers), including non-bank corporates for which there is a required minimum external rating of at least A.<br>The US definition of eligible guarantors under the Standardized Approach NPR does not require a minimum external rating for non-bank corporate entities. The risk weight assigned to a non-bank corporate entity as guarantor would be 100%.<br>In addition, there are no US rules requiring a bank purchasing credit protection to deduct from its capital the amount of materiality thresholds on payments below which no payment is made in the event of loss. |

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| Materiality | The materiality could not be assessed quantitatively. Based on qualitative considerations, the assessment team judges the finding regarding non-bank corporate guarantors as potentially material. Regarding the deduction of materiality thresholds, the assessment team has included this topic for the follow-up assessment since (see Annex F). In the absence of data, the team believes it is potentially material. |

### *2.4.2 Credit risk: Internal ratings-based approach*

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| **Section Grading** | (LC) |
| **Summary** | Although some of the deviations of the US regulation from the Basel text are relevant and potentially material (eg incomplete criteria for QRE, and no dilution risk for purchased receivables), the IRB framework can be deemed as largely compliant with the Basel framework. |
| **Overview of findings by Basel II paragraph(s):** | |
| Basel paragraph(s) | 231-233: Definition of retail exposures |
| Reference in the domestic regulation | Basel III NPR, Section 2 |
| Findings | The definition of residential mortgage exposures under Basel II excludes credit extended to subjects that are not individuals (para 231), while, according to the US definition, residential mortgage exposures are not limited to credit extended to individuals. Specifically, the US agencies have clarified that banks are allowed to classify loans to a business or corporation as a residential mortgage loan if the loan is managed as a segment. Even though the US agencies consider it unlikely for exposures to non-individuals to be classified as residential mortgages, no data are available to assess the materiality of this issue, as “banks do not capture mortgage loan data by borrower type (individual versus business)”. |
| Materiality | Due to lack of data on this specific issue, it is not possible to provide a quantitative assessment of its materiality. From a purely qualitative point of view, the issue could be not particularly material, ie the share of assets which should be classified as ”corporate” or ”other retail” according to Basel rules and are classified as ”residential mortgage” under the US rules is unlikely to be large. The assessment team judges the finding as unlikely to be material. |
| Basel paragraph(s) | 234: Definition of qualified revolving retail exposures |
| Reference in the domestic regulation | Advanced Approaches NPR, Section 101 |
| Findings | Qualifying Revolving Retail Exposures – which attract a lower capital charge with respect to other retail exposures – are defined by Basel III on the grounds of 6 criteria; only the first three (a to c) are explicitly mentioned in the US rule, the following are not included:<br>(d) banks demonstrate that QRE portfolios exhibit low volatility of loss rates, relative to average;<br>(e) banks retain data on loss rates for analysis;<br>(f) supervisor “concur(s) that treatment as a QRE is consistent with the underlying risk characteristics of the portfolio”. |

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| | It is a clear and explicit requirement of Basel II that the low loss rate volatility of exposures which are allowed the preferential treatment for QRRE needs to be proved by banks (and required by supervisors), rather than simply assumed. The fact that the "low volatility" concept is not further specified in terms of a "hard" threshold does not entail that it is not binding or that national supervisors are not expected to endeavour to make it as operational as possible.<br><br>It cannot be excluded that the preferential treatment for QRRE is applied to a higher share of exposures than it would be the case following all of the Basel criteria. |
| Materiality | The scope and detail of the data received is not sufficient to exclude that the preferential treatment for QRRE be applied to a higher share of exposures than it would be the case following all of the Basel criteria. Consequently, the assessment team considers this issue as potentially material and has listed it for further follow-up analysis (see Annex F). |
| Basel paragraph(s) | 270-272: Corporate, sovereign, and bank exposures<br><br>– Formula for derivation of risk-weighted assets (amended by BIII) |
| Reference in the domestic regulation | Advanced Approaches NPR: paragraph 131 |
| Findings | Under Basel II, the capital requirement for a defaulted exposure to corporates, sovereigns and banks is given by the greater of zero and the difference between its LGD and the bank's best estimate of its expected loss (BEEL). According to US rules, the capital requirement has to be calculated as EAD*0.08, while the comparison between LGD and BEEL is not mentioned. |
| Materiality | Currently, the percentage of EAD of defaulted wholesale exposures to the total EAD of wholesale exposures is approximately 0.687%. However no data are available on the comparison between the US rule (8% of EAD, the latter net of write-offs) and the Basel rule (difference between LGD and BEEL). Consequently, for this specific issue it is not possible to provide a quantitative assessment of its materiality. Based on qualitative considerations, the assessment team considers it as potentially material and has listed the issue for further follow-up analysis (see Annex F). |
| Basel paragraph(s) | 327-330: Retail exposures<br><br>– Risk-weighted assets |
| Reference in the domestic regulation | Advanced Approaches NPR: paragraph 131 |
| Findings | Under Basel II, the capital requirement for a defaulted retail exposure is given by the greater of zero and the difference between its LGD and the bank's best estimate of its expected loss (BEEL). According to US rules, the capital requirement has to be calculated as EAD*0.08, while the comparison between LGD and BEEL is not mentioned. The US agencies have indicated that a bank must charge off defaulted retail exposures to their expected recoverable value less the cost to recover and that the LGD after charge off should be zero. This interpretation is not consistent with Basel because the LGD to be compared with the BEEL is a "downturn" one and it is aimed at capturing the unexpected (versus expected) component of losses. |
| Materiality | For five internationally active banks, the EAD for defaulted retail exposures as a percentage of the EAD for all retail exposures is approximately 4.87%. |

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| | The US agencies claim that, given their policy for defaulted retail exposures, there should be little or no expected or unexpected loss for such exposures. However, in the absence of specific data on the different capital charges on defaulted retail exposures under Basel and US rules, it cannot be excluded that the difference is material. The assessment team judges the finding as potentially material and has listed the issue for further follow-up analysis (see Annex F). |
| Basel paragraph(s) | 340-358: Equity exposures<br>– Risk-weighted assets |
| Reference in the domestic regulation | Advanced Approaches NPR: paragraph 152 |
| Findings | Para 345 of Basel II details the conditions for short cash positions and derivative instruments held in the banking book to offset long positions in the same individual stocks.<br>The US rule is more conservative than the Basel one for the following aspects:<br>• it requires a 100% risk weight on a perfectly matched transaction (while the Basel text allows a complete offset);<br>• it requires an ex ante and ex post statistical demonstration of the effectiveness of the hedge (absent in Basel II).<br>On the other hand, the US rule is less conservative than Basel in that it requires the hedging instrument and the hedged item to have at least 3 months of remaining maturity, as opposed to one year at least, as required by Basel. |
| Materiality | Due to lack of data on this specific issue, it is not possible to provide a quantitative assessment of its materiality. From a purely qualitative point of view, the issue could be not particularly material, ie the charge-reducing effect of the different requirement for remaining maturity could be more than compensated by the other differences identified or could be not significant anyway. The assessment team judges the finding as unlikely to be material. |
| Basel paragraph(s) | 363-373: Purchased receivables |
| Reference in the domestic regulation | Advanced Approaches NPR: paragraph 131 |
| Findings | Para 369 and 370 of Basel II introduce a capital charge for dilution risk of purchased receivables “unless the bank can demonstrate to its supervisor that such dilution risk is immaterial”.<br>The capital charge for dilution risk is absent in the US rules. |
| Materiality | The US agencies provided data from three US banking organisations to show that the notional amount of purchased receivables (wholesale or retail) as a percentage of on-balance sheet assets is immaterial. While indicative, at this point the assessment team considers the information too limited in scope and detail to provide sufficient comfort about the non-materiality of the issue. The issue could become material in the future if US banks were to increase their exposures to purchased receivables. The assessment team judges the finding as potentially material and has listed the issue for further follow-up analysis (see Annex F). |
| Basel paragraph(s) | 375-386: Treatment of expected losses and recognition of provisions |
| Reference in the domestic regulation | Basel III NPR, Section 2 |

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| Findings | The Basel text (para 376) defines expected losses (EL) for the bank, sovereign, corporate and retail asset classes as PD*LGD for non-defaulted exposures and as their best estimate of expected loss (BEEL) for defaulted exposures.<br><br>The US definition of Expected credit loss deviates from the Basel II definition as regards:<br><br>(a) "a wholesale exposure to a non-defaulted obligor or segment of non-defaulted retail exposures that is carried at fair value with gains and losses flowing through earnings or that is classified as held-for-sale and is carried at the lower of cost or fair value with losses flowing through earnings", where the expected credit loss (ECL) is set at zero (instead of PD x LGD); the US agencies observe that "By fair valuing the exposures, the expected credit losses are already fully reflected in capital"; in particular, under US GAAP fair value represents the "exit price" - that is, how much a seller would receive when selling an asset or pay to transfer a liability - and lifetime credit impairment (not just incurred loss) would already be considered in the fair value marks.<br><br>(b) "a wholesale exposure to a defaulted obligor or segment of defaulted retail exposures", where ECL equals the bank's impairment estimate for allowance purposes, which is based on accounting measures of credit loss incorporated into a bank's charge-off and reserving practices (instead of the best estimate within the meaning of para 471 of Basel II). The impairment estimate does not align to an estimate of the expected losses; eg the costs of the workout procedure on a loan are not necessarily incorporated into the impairment estimate. |
| Materiality | Regarding point (b) the US agencies provided data from three US banking organisations that shows that the workout costs for wholesale exposures are generally quite small. While indicative, at this point the assessment team considers the information too limited in scope and detail to provide sufficient comfort about the non-materiality of the issue. From a purely qualitative point of view, the assessment team judges that the issue could be material, as the definition of expected losses for both defaulted and non-defaulted exposures is relevant for the determining the capital charges. The assessment team judges the finding as potentially material and has listed the issue for further follow-up analysis (see Annex F). |
| Basel paragraph(s) | 394-421: Minimum requirements for IRB approach<br><br>– Rating system design |
| Reference in the domestic regulation | Advanced Approaches NPR, Section 122 |
| Findings | The new para 415(i) of Basel II (as introduced by para 112 of Basel III) requires that "PD estimates for borrowers that are highly leveraged or for borrowers whose assets are predominantly traded assets must reflect the performance of the underlying assets based on periods of stressed volatilities".<br><br>This has not been transposed into US rules. |
| Materiality | Based on qualitative considerations, the assessment team judges the finding as not material. |
| Basel paragraph(s) | 422-433: Minimum requirements for IRB approach<br><br>– Rating system operations: Coverage of ratings; integrity of rating |

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| | process; overrides; data maintenance |
| Reference in the domestic regulation | Advanced Approaches NPR, Section 122 |
| Findings | Most aspects mentioned in para 423 of Basel II (rating policies regarding the treatment of individual entities in a connected group and including identification of specific wrong-way risk) are detailed in the US agencies' "Work Program". However, the requirement that such policies include the identification of specific wrong-way risk - as prescribed by the new version of para 423 introduced by BIII – is not mentioned.<br>The requirements in para 423, 424, 428, 429, 430, 431, 433 are also mentioned only in the "Work Program".<br>As the Work Program cannot be considered part of the official US regulation and is not submitted systematically to banks as a set of binding requirements, the US regulation is found to be not fully consistent in detailing the minimum requirement for rating system under the IRB approach according to the Basel text. |
| Materiality | The issue cannot be assessed quantitatively. Based on qualitative considerations, the assessment team judges the finding as not material. |
| Basel paragraph(s) | 438-445: Minimum requirements for IRB approach<br>– Corporate governance and oversight<br>– Use of internal ratings |
| Reference in the domestic regulation | Advanced Approaches NPR, Section 122 |
| Findings | Para 445 of the Basel text require a bank to "demonstrate that it has been using a rating system that was broadly in line with the minimum requirements articulated in this document for at least the three years prior to qualification".<br>This use test requirement is not present in the US rules.<br>The 3-year use test is an essential requirement stated by the Basel text for IRB banks. From a practical point of view, all "core" banks developing IRB systems have been in "parallel run" for several years now, so that they are likely to have passed the 3-year use test. However, in the future other banks could be authorised to adopt an IRB system for regulatory purposes without being required to satisfy the 3-year use test requirement. |
| Materiality | The issue cannot be assessed quantitatively. Based on qualitative considerations, the assessment team judges the finding as not material. |
| Basel paragraph(s) | 468-473: Minimum requirements for IRB approach<br>– Risk quantification: Requirements specific to own-LGD estimates |
| Reference in the domestic regulation | Advanced Approaches NPR, Sections 2, 122 |
| Findings | According to para 469 of the Basel text, in estimating LGDs AIRB banks are required to "consider the extent of any dependence between the risk of the borrower and that of the collateral or collateral provider".<br>This has not been transposed into US rules. |
| Materiality | The issue cannot be assessed from a quantitative point of view as it |

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| | concerns an operational requirement. Based on qualitative considerations, the assessment team judges the finding as not material. |
| Basel paragraph(s) | 474-479: Minimum requirements for IRB approach<br>– Risk quantification: Requirements specific to own-EAD estimates |
| Reference in the domestic regulation | Advanced Approaches NPR, Sections 2, 122 |
| Findings | The Basel text require an AIRB bank to incorporate a larger margin of conservatism banks have to incorporate in its EAD estimates when there is correlation between PD and EAD (para 475) and to “consider its ability and willingness to prevent further drawings in circumstances short of payment default, such as covenant violations or other technical default events” (para 477).<br>The two requirements have not been transposed into US rules. |
| Materiality | The issue cannot be assessed from a quantitative point of view as it concerns an operational requirement. Based on qualitative considerations, the assessment team judges the finding as not material. |
| Basel paragraph(s) | 480-490: Minimum requirements for IRB approach<br>– Risk quantification: Minimum requirements for assessing effect of guarantees and credit derivatives |
| Reference in the domestic regulation | Part 1, Sect 2; Part IV, Sect 33; 72 FR 69397-69405, 69416 |
| Findings | The Basel text require banks to adopt specific and detailed criteria to address – when adjusting borrower grades or LGD estimates – the guarantor’s ability and willingness to perform under the guarantee, the likely timing of any payments, the degree to which the guarantor’s ability to perform under the guarantee is correlated with the borrower’s ability to repay and the extent to which residual risk to the borrower remains (para 486).<br>In addition, for credit derivatives the criteria must address the impact of their payout structure on the timing of recoveries and the extent to which other forms of residual risk remain (para 489).<br>These requirements have not been transposed into US rules. |
| Materiality | The issue cannot be assessed under a quantitative point of view as it concerns an operational requirement. Based on qualitative considerations, the assessment team judges the finding as not material. |
| Basel paragraph(s) | 491-499: Minimum requirements for IRB approach<br>– Risk quantification: Requirements specific to estimating PD and LGD (or EL) for qualifying purchased receivables |
| Reference in the domestic regulation | ”Work Program” |
| Findings | The requirements for the estimation of risk components for purchased receivables (para 491-499 of the Basel text) are detailed – in a form broadly consistent with Basel II - in the “Work Program”.<br>As the Work Program cannot be considered part of the official US regulation and is not submitted systematically to banks as a set of binding requirements, the US regulation is assessed as not fully consistent in detailing the minimum requirement for the estimation of |

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| | risk components for purchased receivables according to the Basel text. |
| Materiality | The information received from the US agencies suggests that the current materiality of exposures in purchased receivables is low. Based on this and qualitative considerations, the assessment team judges the finding as not material |
| Basel paragraph(s) | 523-524: Minimum requirements for IRB approach<br><br>–Requirements for recognition of leasing |
| Reference in the domestic regulation | Advanced Approaches NPR: paragraph 131 |
| Findings | According to para 524 of the Basel text, leases that expose the bank to residual value risk need to be split in two components: the discounted lease payment stream and the residual value, the latter risk-weighted at 100%.<br><br>Under US rules, the residual value for wholesale leases is risk-weighted as the remaining part of the exposure, which could attract a risk-weight higher or lower that 100%. |
| Materiality | In the absence of supporting data quantifying the impact of this difference, it cannot be excluded that the US treatment be less strict than the Basel one. The assessment team judges the finding as potentially material. |

### *2.4.3 Securitisation framework*

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| **Section Grading** | (MNC) |
| **Summary** | Pursuant to the Dodd-Frank Act, the US rules regarding securitisation do not include any provision relating to the Basel Ratings-Based Approach (RBA) and accordingly provide alternative treatments. The risk weights resulting from the US simplified supervisory formula (SFFA) approach are based on the (fixed) standardised approaches risk weights and (variable) delinquency rates for the underlying asset pools, plus a supervisory add-on based on whether the exposure is a securitisation exposure or re-securitisation exposure. The limited data provided by the US agencies suggest that the US approach can result in risk weights that are significantly higher on average than risk weights calculated under the Basel RBA approach but that can also be lower for certain downgraded senior securitisation exposures. According to information provided by the US agencies, non-trading securitisation exposures subject to the RBA approach and trading book securitisation exposures represented, respectively, approximately 1.6% and 0.5% of total assets of the 11 banks under parallel run as of end-March 2012. Nevertheless, the relative importance of exposures could rise in the future. The assessment team considers more comprehensive data and further analysis is required to assess the materiality of the differences and has listed the item for the follow-up assessment (see Annex F). |
| **Overview of findings by Basel II paragraph(s):** | |
| Basel paragraph(s) | 553-559: Operational requirements for the recognition of risk transfer. |
| Reference in the domestic regulation | Part V, Sect 41(a); 72 FR 69419 |
| Findings | Basel II para 555e requires the prohibition of significant materiality |

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| | thresholds below which credit protection is deemed not to be triggered even if a credit event occurs. This provision is not covered by the US regulations. |
| Materiality | The materiality has not been assessed quantitatively due to lack of data. Based on qualitative considerations, the assessment team judges the finding as unlikely to be material. |
| Basel paragraph(s) | 566-576: Standardised approach for securitisation exposures (amended by Basel III) – Scope; risk weights; exceptions<br><br>606-610: IRB approach for securitisation exposures – Scope; hierarchy of approaches; max. capital requirement<br><br>611-618: IRB approach for securitisation exposures (amended by Basel 2.5 and III) – Ratings-Based Approach (RBA) |
| Reference in the domestic regulation | Standardized Approach NPR<br><br>Sect 22(f), 72 FR 69407; Sect 42, 72 FR 69419<br><br>Sect 2, 72 FR 69402; Sect 2, 72 FR 69404; Sect 43, 72 FR 69420 |
| Findings | The NPR provides core banks for an alternative between SSFA and exceptional treatments. The latter differ from those set out in para 571 to para 576 of Basel II. The limited data provided by the US agencies simulating the impact of both approaches on a sample of securitisation deals suggest that the US approach can result in risk weights that are significantly higher on average than risk weights calculated under the Basel RBA approach but that can also be lower depending on the type of securitisation and on circumstances that may lead to sharp downgrades in ratings. For example, in the data provided the SSFA would have tended to result in much higher risk weights than the RBA early in the life of the securitisation deals but would have tended to fall substantially short in some cases at later stages. The differences seems to be driven by the RBA risk weights responding strongly to the downgrades of the securitisations, while the SSFA risk weights responded less strongly to the deteriorating quality of the underlying exposures (the SSFA does not respond to downgrades, but to actually materialising delinquency rates). This seems particularly the case for RMBS exposures, which are said to account for 50% of non-trading securitisation exposures and 21% of trading securitisation exposures. However, the sample data are not sufficient for a robust assessment of the impact of the differences with respect to the Basel standards on capital requirements or on financial stability. The US agencies have reported that they are conducting a more comprehensive quantitative analysis comparing the new proposed approaches with the Basel approaches over time. |
| Materiality | Although according to information provided by the US agencies, non-trading securitisation exposures subject to the RBA approach and trading book securitisation exposures represented, respectively, approximately 1.6% and 0.5% of total assets of the 11 banks under parallel run as of end-March 2012, the relative importance of exposures could rise in the future. Based on a quantitative and qualitative assessment, the assessment team judges the finding is potentially material. Since the available data has not allowed the team to assess the materiality more accurately, the issue has been listed for further follow-up analysis (see Annex F). |
| Basel paragraph(s) | 577-582: Standardised approach for securitisation exposures (amended by Basel 2.5) – Credit conversion factors for off-balance sheet exposures |
| Reference in the domestic | Standardized Approach NPR; Advanced Approach NPR |

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| regulation | |
| Findings | 1. The definition of eligible servicer cash advance facility in the Standardized Approach NPR (pages 79 and 166) is less stringent than that of para 582 of Basel II. However, this deviation is intended to allow inclusion of advances made to cover foreclosure costs or other expenses to facilitate the timely collection of the underlying exposures. The agencies claim that this is a standard market practice and that losses are immaterial.<br><br>2. The definition of an eligible liquidity facility in the Standardized Approach NPR (page 163) differs from that of para 578 of Basel II. Three deviations have been assessed in this regard. However, they have to be considered in view of the materiality of the liquidity facilities to third-party conduits (although partial, provided data suggests low materiality) and the fact that FAS 166/167 require consolidation of the in-house conduits.<br><br>3. The reduction "of the notional amount of an eligible ABCP liquidity facility to the maximum potential amount that the [BANK] could be required to fund given the ABCP program's current underlying assets" (Standardized Approach NPR page 77) is not consistent with the treatment of revised para 579 of Basel II. |
| Materiality | Based on the available data and qualitative information the assessment team judges the finding is not material. |
| Basel paragraph(s) | 637-639: IRB approach for securitisation exposures (amended by Basel 2.5) – Liquidity facilities |
| Reference in the domestic regulation | Advanced Approach NPR<br><br>Sect 42(e), 72 FR 69419 |
| Findings | 1) The definition of an eligible liquidity facility in the Advanced Approach NPR (page 163) differs from that of para 578 of Basel II.<br><br>2) The reduction "of the notional amount of an eligible ABCP liquidity facility to the maximum potential amount that the [BANK] could be required to fund given the ABCP program's current underlying assets" (Advanced Approach NPR page 121) is not consistent with the treatment of para 637 to 639 of Basel II. |
| Materiality | Based on the available data and qualitative information the assessment team judges the finding is not material. (see para 577-582) |
| Basel paragraph(s) | 640-643: IRB approach for securitisation exposures – Treatment of overlapping exposures; eligible servicer cash advance facilities; treatment of CRM for securitisation exposures; capital requirement for early amortisation provisions |
| Reference in the domestic regulation | Advanced Approach NPR<br><br>Sect 42, 72 FR 69419-69420; Sect 2, 72 FR 69400; Sect 46, 72 FR 69424; Sect 47, 72 FR 69425 |
| Findings | The "eligible" status is also granted to servicer cash advance facilities that oblige the servicer to make non-reimbursable advances, provided "such advance is contractually limited to an insignificant amount of the outstanding principal balance of that exposure". This treatment is less stringent than Basel II (para 641/582). However, this deviation is |

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| | intended to allow inclusion of advances made to cover foreclosure costs or other expenses to facilitate the timely collection of the underlying exposures. The agencies claim that this is a standard market practice and that losses are immaterial. |
| Materiality | Based on qualitative considerations, the assessment team judges the finding as not material. |

### 2.4.4 Counterparty credit risk rules

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| **Section Grading** | (LC) |
| **Summary** | Although the treatment of counterparty credit risk conforms substantially to the rules of Basel II and III, the definition of specific wrong-way risk differs from that of Basel and may lead to an underestimation of counterparty risk. |
| **Overview of findings by Basel II Annex 4 paragraph(s):** | |
| Basel paragraph(s) | 55-58: Internal Models Method – Operational requirements for EPE models (stress testing and wrong-way risk) (amended by Basel III) |
| Reference in the domestic regulation | Basel III NPR, Section 2; Advanced Approach NPR Sect 122 (i) (6), Sect 132 (d) |
| Findings | New para 56 of Annex 4 (as amended by para 115 of Basel III) details the qualitative requirements for stress testing that banks must perform when using the internal model method for counterparty credit risk.<br><br>New para 57 (as amended by para 100 of Basel III) details the use of stress testing and scenario analyses to identify wrong-way risk.<br><br>These two requirements are broadly incorporated in the Interagency Supervisory Guidance on Counterparty Credit Risk Management of June 29, 2011), which, however, falls short of fully incorporating the provisions on wrong-way risk contained in Basel para 57.<br><br>Moreover, new para 58 (as amended by para 100 of Basel III) defines specific wrong-way risk as a situation where "future exposure to a specific counterparty is highly correlated with the counterparty's probability of default". The US rules define it instead as "a type of wrong way risk that arises when both the counterparty and issuer of the collateral supporting the transaction, or the counterparty and the reference asset of the transaction, are affiliates or are the same entity". The definition of "specific wrong-way risk" is narrower than the one adopted in Basel III and could lead to an underestimation of counterparty risk. |
| Materiality | The materiality could not be assessed quantitatively due to insufficient data. Based on qualitative considerations, the assessment team judges the finding as potentially material. The issue has been listed for further follow-up analysis (see Annex F). |
| Basel paragraph(s) | 91-96: Current Exposure Method |
| Reference in the domestic regulation | Advanced Approach NPR: paragraph 132(b)2(ii) |
| Findings | New para 151 of Basel II (CRM), as amended by para 111 of Basel III, changes the table of standard supervisory haircuts, which are partly based on external ratings.<br><br>Due to Section 939A of the DFA, supervisory haircuts in the US rules are no longer based on external ratings; moreover, a new haircut of |

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| | 25% is introduced (for non-sovereign issuers that receive a 100% risk weight), which is not contemplated by Basel III; by reference to para 32 of the Standardised Approach NPR, this entails that a 25% haircut will apply to all corporate issuers, which is a more conservative treatment for those securities that would be eligible under Basel III (ie with rating not worse than BBB-), but is less conservative with respect to those securities that would not be eligible under Basel III. |
| Materiality | Due to the different credit quality metrics adopted, the issue cannot be assessed from a quantitative point of view. Based on qualitative considerations, the assessment team judges the finding as unlikely to be material as non-investment grade corporate securities are not expected to be used intensely as collateral. |
| Basel paragraph(s) | 104-105: CVA capital charges – Standardised |
| Reference in the domestic regulation | Advanced Approach NPR: paragraph 132(e)5 |
| Findings | Under new para 104 of Annex 4 on the standardised Credit Value Adjustment (CVA) charge (as introduced by para 99 of Basel III) banks are allowed to subtract from the notional amount of index CDS hedges the notional amount attributable to the single name hedged by and constituent of the index, subject to supervisory approval.<br><br>In the US rules (para 132(e)5(ii)) supervisory approval is not required.<br><br>Moreover, new para 104 of Annex 4 (as introduced by para 99 of Basel III) incorporates a table of weights for the standardised CVA charge based on external ratings.<br><br>In order to comply with section 939A of the Dodd-Frank (requirement to remove references to ratings), the US NPR proposes a table of weights based on internal PDs, instead of ratings (para 132(e)5(i)). The mapping between ratings and PDs is based on the default rate statistics of a rating agency (S&P's); this, however, does not guarantee equivalence with the BIII table, as internal ratings and their associated default rates may (and generally do) differ from the external ratings and their associated default rates in a number of aspects (such as the definition of default, the information set underlying the rating assignment process, etc). |
| Materiality | Due to the different credit quality metrics adopted, the issue cannot be assessed from a quantitative point of view. Based on qualitative considerations, the assessment team judges the finding as not material. |

### 2.4.5 Market risk: standardised measurement method

| | |
|---|---|
| **Section Grading** | C |
| **Summary** | The US rules implement only certain provisions of the standardised market risk framework. Notwithstanding a deviation from the Basel text, the rules can be considered as substantially consistent with the Basel framework. |
| **Overview of findings by Basel II paragraph(s):** | |
| Basel paragraph(s) | 709(i)-709(ii): Market risk – The standardised measurement method: Interest rate risk (amended by Basel 2.5) |
| Reference in the domestic regulation | Market Risk Final Rule: Sec 10 |
| Findings | According to new para 709(ii -1-) of the Basel text (as introduced by |

| | |
|---|---|
| | para 16 of Basel 2.5), the specific risk capital charge for securitisation instruments excluded from the correlation trading portfolio can be computed as Max[Long; Short] only during a transitional period (until 31 Dec 2013), but this transitional provision is not mentioned in the US rules (sec 10(d)).<br><br>In the preamble of the Final Rule on Market Risk, it is said that: "The agencies anticipate potential reconsideration of this provision at a future date"; this is different from Basel 2.5, where a transitional period (until 31 Dec 2013) is explicitly introduced. |
| Materiality | At the time this report was completed, the finding was not material. The assessment team nevertheless notes the issue as a reminder for the follow-up assessment (see Annex F). |

### 2.4.6 Market risk: internal models approach

| **Section Grading** | C |
|---|---|
| **Summary** | Notwithstanding two minor deviations from the Basel text (related to certain operational requirements), the rules can be considered as substantially consistent with the Basel framework. |
| **Overview of findings by Basel II paragraph(s):** | |
| Basel paragraph(s) | 718(Lxxxvii)-718(XCviii): Treatment of specific risk (amended by B2.5) |
| Reference in the domestic regulation | Market Risk Final Rule, para 7-9 |
| Findings | 1. No explicit reference to backtesting for specific risk (Basel II, new para 718(LXXXVIII) and 718(XCI – 1)).<br><br>2. No explicit reference to validation for incremental risk ("Guidelines for computing capital for incremental risk in the trading book", para 32). |
| Materiality | Based on qualitative considerations, the assessment team judges the finding as not material. These criteria relate to certain operational requirements, the materiality of which is assessed to be low. |
| Basel paragraph(s) | 718(XCix): Model validation standards (amended by B2.5) |
| Reference in the domestic regulation | Market Risk Final Rule, Sect 3-4 |
| Findings | No reference in the rules to the detailed prescriptions of Basel on model validation. |
| Materiality | Based on qualitative considerations, the assessment team judges the finding as not material. These criteria relate to certain operational requirements, the materiality of which is assessed to be low. |

### 2.4.7 Operational risk: basic indicator approach and standardised approach

| **Section Grading** | N/A |
|---|---|
| **Summary** | This approach has not been implemented. |
| **Overview of findings by Basel II paragraph(s):** | |
| Basel paragraph(s) | 649-654; 660-663: Measurement methodologies and qualifying criteria |

| | |
|---|---|
| Reference in the domestic regulation | |
| Findings | |
| Materiality | |

### 2.4.8 Operational risk: advanced measurement approaches

| | |
|---|---|
| **Section Grading** | LC |
| **Summary** | The US approach deviates in a number of areas from Basel III, for example regarding certain requirements for the choice of risk factors for operational risk measurement, which could potentially lead to a less robust operational risk measurement framework for US banks. However, the US approach is largely consistent with Basel. |
| **Overview of findings by Basel II paragraph(s):** | |
| Basel paragraph(s) | 655-659 and 664-665: Measurement methodologies and qualifying criteria – Advanced Measurement Approaches (AMA): General standards |
| Reference in the domestic regulation | Sect 22(h)(3); 72 FR 69408 |
| Findings | 1. There is no explicit rule implementing para 656 that states that a bank adopting the AMA may, with the approval of its host supervisors and the support of its home supervisor, use an allocation mechanism for the purpose for determining the regulatory capital requirement for internationally active banking subsidiaries. The AMA guidance document does not explicitly implement the requirements either.<br>2. The second part of para 657, which states that the diversification benefits should not be incorporated in cases where the stand alone capital requirements are considered appropriate (eg where the subsidiary is considererd to be significant), has been implemented in a limited way. Secton 22(h)(3)(ii)(c) provides that subsidiary banks of a holding company that is required to use the AMA may use an alternative approach, but in such case it may not use the diversification benefits of the parent company or other subsidiaries of the parent company. The AMA guidance document does not explicitly implement the requirements either.<br>3. The US rules allow for the use of an alternative operational risk quantification system that does not have to meet the Basel criteria for AMA (it is subject to supervisory approval; the latter is based on a series of principles). According to the preamble to the 7 December 2007 rules (see p. 69318), the alternative approach is not available to bank holding companies (BHCs). It would appear, based on what stated in the preamble, that such approaches are available for situations where there is not sufficient operational loss data available.<br>US authorities indicated that uncertainty in quantification and insufficient resources are also recognised as justifiable reasons for allowing the use of an alternative approach. |

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| Materiality | Based on qualitative considerations, the assessment team assesses the difference as not material, provided that the approval of the alternative approach is limited to situations described above. |
| Basel paragraph(s) | 666: Qualifying criteria – Advanced Measurement Approaches (AMA): Qualitative standards |
| Reference in the domestic regulation | Sect 22(h), Sect 22(j), 72 FR 69407-69408; Sect 21, 72 FR 69406 |
| Findings | 1. There is no explicit rule implementing the requirement of close integration of the operational risk measurement system of para 666(b) and it is not clear whether there is a rule implementing this requirement implicitly. The AMA guidance document does not explicitly implement the requirement either.<br>2. The US rules require an internal audit of the effectiveness of the controls supporting the bank's advanced systems. Para 666(e) of Basel II requires the audit to cover the activities of the business units and the independent operational risk management function. The scope of the audit as foreseen in the US rules would therefore seem to be more limited than the one in Basel II. The preamble to the rules (see p. 69320) does provide some detail on this matter. It states that "internal audit should evaluate the depth, scope, and quality of the risk management system review process and conduct appropriate testing to ensure that the conclusions of these reviews are well founded." This would appear to cover the risk management function part of the Basel requirement, but not necessarily the business unit one. No further clarifications on this point were found in the AMA guidance. |
| Materiality | Based on qualitative considerations, the assessment team judges the finding as not material. |
| Basel paragraph(s) | 670-673: Qualifying criteria – Advanced Measurement Approaches (AMA): Quantitative standards (internal data) |
| Reference in the domestic regulation | Sect 22(h)(2), 72 FR 69408; Sect 2, 72 FR 69402 |
| Findings | 1. The US rules allow for an observation period of internal loss data shorter than 5 years, which is also possible under the Basel rules. However, whereas the Basel rules seem to put a floor of 3 years for the period, no such limit is established in the US rules. The US rules state that the shorter observation period is only available in transitional situations, such as mergers and acquisitions, and is subject to supervisory approval. The preamble of the rules (see p. 69316) provides an additional example of where the shorter observation period could be approved: a bank's initial implementation of an AMA. No further clarification on this point was found in the AMA guidance.<br>2. The US rules do not contain a provision implementing the first bullet of para 673 that requires banks to have criteria for assigning loss data to business lines and event types. Furthermore, they do not contain a provision implementing the fourth bullet point of that paragraph requiring banks to develop specific criteria for assigning losses arising from a centralised function, or an activity than spans more than one business line, or for related events over time could be found. No language on these issues could be found in the AMA |

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| | guidance either. |
| Materiality | The materiality could not be assessed quantitatively. Based on qualitative considerations, the assessment team judges the finding as unlikely to be material. |
| Basel paragraph(s) | 676: Qualifying criteria – Advanced Measurement Approaches (AMA): Quantitative standards (business environment and internal control) |
| Reference in the domestic regulation | Sect 22(h)(2)(D), 72 FR 69408; Sect 2, 72 FR 69398 |
| Findings | A number of Basel requirements regarding the choice of certain risk factors related to business environment and internal controls appear not explicitly implemented. For example, there is no requirement regarding the need for quantitative verification of such risk factors or the need to capture potential increases in risk due to greater complexity of activities or increased business volume (first two criteria of Basel para 676). |
| Materiality | The materiality could not be assessed quantitatively. Based on qualitative considerations, the assessment team judges the finding as potentially material, as it may lead to a less robust operational risk framework. |
| Basel paragraph(s) | 677-679: Risk mitigation |
| Reference in the domestic regulation | Sect 61, 72 FR 69428 |
| Findings | The US rules allow for risk mitigants other than insurance to be used for the purposes of calculating the capital requirement for operational risk. The Basel II rules only allow for insurance to be used as a risk mitigant.<br><br>According to the feedback from US agencies no alternative risk mitigants have been approved so far. |
| Materiality | The difference is currently not material. However, it could become material in the future, should US agencies approve an alternative form of risk mitigation. |
| Basel paragraph(s) | 680-683: Partial use of AMA |
| Reference in the domestic regulation | |
| Findings | In the self-assessment it is indicated that the agencies' rules do not include a partial use methodology where a bank may be permitted to use an AMA for some parts of its operations and the Basic Indicator Approach or Standardised Approach for the balance. However, the US rules do provide for a partial use methodology (combining AMA and the general risk-based capital rules), as is evident from Section 24 of the rules (M&A transitional arrangements). Relevant text can also be found in the preamble to the 7 December 2007 rules (see p. 69321). Also, partial use on a more permanent basis, at least at consolidated level, would appear to be possible for situations where a bank within a group is allowed to use an alternative approach to operational risk measurement. As US agencies have indicated, such alternative approach could, for instance, be very similar to the Basic Indicator Approach.<br><br>The US rules do not contain language implementing the second part of the second bullet point in para 680. |

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| Materiality | Based on qualitative considerations, the assessment team judges the finding as not material. |

### 2.4.9 Capital buffers (conservation and countercyclical)

| | |
|---|---|
| **Section Grading** | (C) |
| **Summary** | All elements of the Basel III standards for the capital conservation and countercyclical buffers are assessed as implemented through the US Basel III NPR, except for the items detailed below. In the case of the latter, given their nature, the impact of the differences is deemed to be immaterial and cannot in any case be quantitatively assessed. |
| **Overview of findings by Basel III paragraph(s):** | |
| Basel paragraph(s) | 130-131: Capital conservation buffer – Distribution constraints |
| Reference in the domestic regulation | Basel III NPR |
| Findings | The restrictions on distributions are consistent with Basel III. However, US supervisory discretion can allow exceptions if the agency determines that the distribution is not contrary to the purposes of the capital conservation buffer framework or to the safety and soundness of the bank (see paragraph __.11(a)(4)(iv).<br><br>The US agencies have explained that this is a safety clause to deal with exceptional situations. Such Reservation of Authority is a common feature of US regulations to allow the agencies to react on a case by case basis to unforeseen circumstances, including emergencies or requirements in newly enacted Federal laws. As reported by the US agencies, the banking agencies do not often exercise their reservations of authority, and when they do, they generally follow transparent procedures and publish their decisions. US administrative law generally requires agency action to be neither arbitrary nor capricious, which in turn requires that an agency's actions be transparent and supportable by evidence in the public record. |
| Materiality | The finding is currently not material. If the US agencies only exercise the discretion as they have explained, the finding is unlikely to be material. The Basel Committee would need to re-assess the materiality of the impact as and when this discretion is exercised and publicised by the US agencies. |
| Basel paragraph(s) | 142-145: Bank specific countercyclical buffer |
| Reference in the domestic regulation | BIII NPR Sect 11(b)(1)(iii) & (iv), 11(b)(2)(iii) |
| Findings | The definition of the treatment of the value-at-risk (VaR) for specific risk, the incremental risk charge and the comprehensive risk measurement charge is still being consulted with the industry and no proposal has been issued. |
| Materiality | By its nature the impact of the finding cannot be quantitatively assessed. The assessment team judges the finding as not material. |

## 2.5 Pillar 2: Supervisory review process

| | |
|---|---|
| **Section Grading** | C |
| **Summary** | The US adoption of the Pillar 2 is apart from a few minor deviations substantially consistent with Basel. |
| **Overview of findings by Basel paragraph(s):** | |
| Basel paragraph(s) | Basel II 738(v): Market risk: Combination of risk measurement approaches |
| Reference in the domestic regulation | Pillar 2 guidance, 73 FR 44625 |
| Findings | Although banks are required to aggregate their risks and hold capital against all material risks (73 FR 44626, sect 31 and 36), there is no explicit requirement for banks to demonstrate how they combine their different risk measurement approaches to arrive at the overall internal capital for market risk. |
| Materiality | Based on qualitative considerations, the assessment team judges the finding as not material. |
| Basel paragraph(s) | Basel II 767-769 Residual risk |
| Reference in the domestic regulation | Part I, 72 FR 69399-69401, 69403 |
| Findings | According to the Basel text, supervisors should require banks to have in place appropriate written CRM policies and procedures in order to control residual risks. A bank must consider in its CRM policies and procedures whether it is appropriate to give full recognition of the value of the credit risk mitigant and demonstrate that its CRM management policies and procedures are appropriate to the level of capital benefit that it is recognising.<br><br>The US rules and guidance do not explicitly require banks to comply with the above requirements. The US agencies explained that they review and monitor bank policies and procedures as part of the supervisory process, but they did not provide documentation supporting this part of the supervisory process. Therefore the US regulation is not fully consistent with the Basel text in addressing residual risk. |
| Materiality | Based on qualitative considerations, the assessment team judges the finding as not material. |
| Basel paragraph(s) | Basel II 777(i) – 777(xiii) amended by BIII: Counterparty credit risk |
| Reference in the domestic regulation | Part IV, Section 32; 72 FR 69412; Pillar 2 guidance, 73 FR 44625; Interagency Supervisory Guidance on Counterparty Credit Risk (June 29, 2011) |
| Findings | Para 777(x) of BII, which is para 106 in BIII, requires banks to establish a “collateral management unit”; no mention of this has been found in either the rules or the Interagency Supervisory Guidance on Counterparty Credit Risk Management of June 29, 2011. |
| Materiality | Based on qualitative considerations, the assessment team judges the finding as not material. |
| Basel paragraph(s) | Basel II 795: Residual Risk |

| | |
|---|---|
| Reference in the domestic regulation | Sect 41(b)(2); 72 FR 69419; SR Letter 1997-21; SR Letter 2011-1 |
| Findings | Basel stipulates that supervisors will review the appropriateness of banks' approaches to the recognition of credit protection, in particular for first loss credit enhancements in the context of securitisations. Apart from the FRB Supervisory Letter dated 25 January 2011, no interagency rule seems to set out any supervisory expectation for the recognition of protection against first loss credit enhancements and related supervisory actions, if needed. |
| Materiality | Based on qualitative considerations, the assessment team judges the finding as not material. |

### 2.6 Pillar 3: Market discipline

| | |
|---|---|
| **Section Grading** | (C) |
| **Summary** | No material deviations were identified. |
| **Overview of findings by Basel II paragraph(s):** | |
| Basel paragraph(s) | |
| Reference in the domestic regulation | |
| Findings | |
| Materiality | |

# Annexes

## A. Glossary

| | |
|---|---|
| ABA | American Bankers Association |
| ABCP | Asset Backed Commercial Paper |
| AMA | Advanced Measurement Approach (operational risk) |
| BCBS | Basel Committee on Banking Supervision |
| BIS | Bank for International Settlements |
| CCP | Central counterparty |
| CCR | Counterparty Credit Risk |
| CET1 | Core Equity Tier 1 (capital) |
| CVA | Credit Valuation Adjustment |
| DI | Depository Institution |
| EAD | Exposure at Default |
| FC | Financial Company |
| FDIC | Federal Deposit Insurance Corporation |
| FRB | Federal Reserve Board |
| FSR | Financial Services Roundtable |
| FSB | Financial Stability Board |
| GSE | Government Sponsored Enterprise |
| IAA | Internal Advanced Approach (operational risk) |
| IMA | Internal Models Approach (market risk) |
| IRB | Internal Rating Based approach (credit risk) |
| LGD | Loss Given Default |
| NPR | Notice of Proposed Rulemaking |
| OCC | Office of the Comptroller of the Currency |
| OLA | Orderly Liquidation Authority |
| PD | Probability of default |
| PON | Point of Non-Viability |
| PSE | Public sector entity |
| RBA | Ratings-Based Approach |
| RWA | Risk weighted asset |
| SFA | Supervisory Formula Approach (for securitisations) |
| SFT | Securities Financing Transactions |
| SIG | Standards and Implementation Group (BCBS working group) |
| SSFA | Simplified Supervisory Formula Approach (for securitisations) |

# B. Referenced documents

### List of consulted public US documents

- Joint Policy Statement on Interest Rate Risk; SR 96-13
- Risk Management and Capital Adequacy of Exposures Arising from Secondary Market Credit Activities; SR Letter 97-2 (July 1997)
- Federal Reserve Board's Supervisory Letter on Sound Credit Risk Management and the Use of Internal Credit Risk Ratings at Large Banking Organizations; SR 98-25 (September 1998)
- Revised Uniform Retail Credit Classification and Account Management Policy; SR Letter SR00-8 (SUP) (June 2000)
- Comptroller's Handbook on Rating Credit Risk (April 2001)
- Interagency Guidance on Implicit Recourse in Asset Securitizations; OCC 2002-20 (May 2002)
- Risk-Based Capital Regulation amended final rule (February 2003)
- Interagency Credit Risk Management Guidance for Home Equity Lending; SR letter 05-11 (May 2005)
- Credit Risk Management Guidance for Home Equity Lending (May 2005)
- CFR 2006 title 12 volume 7 chapter IX Subchapter E - Federal Home Loan Bank Risk Management and Capital Standards Part 930 – 933.5
- Risk-Based Capital Regulation Amendment Final Rule; Federal Registrar / Vol. 71, No. 240 (December 2006)
- Interagency Policy Statement on the Allowance for Loan and Lease Losses; OCC 2006-47 (December 2006)
- Risk-Based Capital Standards: Advanced Capital Adequacy Framework—Basel II; Final Rule (December 2007)
- Supervisory Guidance: Supervisory Review Process of Capital Adequacy (Pillar 2) Related to the Implementation of the Basel II Advanced Capital Framework (July 2008)
- CRS Report for Congress Fannie Mae and Freddie Mac in Conservatorship (September 2008)
- Consolidations (Topic 810) – Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities - Financial Accounting Standards Board No. 2009-17 (December 2009)
- Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Regulatory Capital; Impact of Modifications to Generally Accepted Accounting Principles; Consolidation of Asset-Backed Commercial Paper Programs; and Other Related Issues (January 2010)
- Guidance on Sound Incentive Compensation Policies; Federal Register / Vol. 75, No. 122 (June 2010)
- Federal Home Loan Mortgage Corporation Act Public Law No. 91-351, 84 Stat 450 Approved July 24, 1970 as amended through July 21, 2010
- Interagency Appraisal and Evaluation Guidelines; SR letter 10-16 (December, 2010)

- Impact of High-Cost Credit Protection Transactions on the Assessment of Capital Adequacy; SR Letter 11-1 (January 2011)
- Incentive-Based Compensation Arrangements; Federal Register / Vol. 76, No. 72 (April 2011)
- Supervisory Guidance on Model Risk Management; SR Letter 11-7 (April 2011)
- Fair Value Measurement (Topic 820) – Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs; FASB (May 2011)
- Final rule on Conservatorship and Receivership; Federal Housing Finance Agency 76 FR 35724 (June 2011)
- Interagency Supervisory Guidance on Counterparty Credit Risk Management (June 2011)
- Risk-Based Capital Standards: Advanced Capital Adequacy Framework—Basel II; Establishment of a Risk-Based Capital Floor (June 2011)
- Interagency Guidance on the Advanced Measurement Approaches for Operational Risk; OCC 2011-21 (June 2011)
- Capital Plans; Federal Register / Vol. 76, No. 231 (December 2011)
- Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies (NPR); Federal Register / Vol. 77, No. 3 (January 2012)
- Annual Stress Test (NPR); Federal Register / Vol. 77, No. 15 (January 2012)
- Interagency Advisory on Interest Rate Risk Management Frequently Asked Questions (January 2012)
- Re: Risk-Based Capital Guidelines: Market Risk; Alternatives to Credit Ratings for Debt and Securitization Positions; comment letter from THC, ABA, ASF, FSR, ISDA and SIFMA (February 2012)
- Supervisory Guidance on Stress Testing for Banking Organizations With More Than USD 10 Billion in Total Consolidated Assets; Federal Register / Vol. 77, No. 96 (May 2012)
- Statement to Clarify Supervisory Expectations for Stress Testing by Community Banks (May 2012)
- Financial Accounting Standards Board 210 Balance Sheet 20 Offsetting (June 2012)
- OCC's Alternatives to the Use of External Credit Ratings in the Regulations of the OCC Final Rule 77 FR 35253 (June 2012)
- OCC's Guidance on Due Diligence Requirements in Determining Whether Securities Are Eligible for Investment, final guidance; 77 FR 35259 (June 2012)
- NPR on Enterprise Underwriting Standards; Federal Housing Finance Agency 77 FR 36086 (June 2012)
- Federal Reserve's Commercial Bank Examination Manual
- Federal National Mortgage Association Charter Act
- Fed Reserve's Trading and Capital-Markets Activities Manual
- Dodd-Frank Wall Street Reform and Consumer Protection Act (July 2010)
- Federal Deposit Insurance Act

- Interagency guidelines establishing standards for safety and soundness (12 CFR Part 208 Appendix D-1)
- Real Estate Lending Standards Regulations and Guidelines (12 CFR 208 subpart E and Appendix C)
- Real Estate Appraisal Regulation 12 CFR 208 subpart E and 225 subpart G)
- Federal Reserve Examination Procedures: Commercial and industrial loans (Examination Modules 09/09)
- Federal Reserve Examination Procedures: Loan portfolio management and review: general (Examination Modules 09/11)

**Other consulted public documents**

- Financial Sector Assessment Program – United States of America (May 2010)
- Criteria for Assessing Basel II Preparedness and U.S. FSAP – Adapted and Simplified from Normal Basel II Assessment criteria (May 2010)

**List of Basel documents**

- Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework - Comprehensive Version (June 2006)
- Enhancements to the Basel II framework (July 2009)
- Guidelines for computing capital for incremental risk in the trading book (July 2009)
- Basel III: International framework for liquidity risk measurement, standards and monitoring (December 2010)
- Final elements of the reforms to raise the quality of regulatory capital issued by the Basel Committee (January 2011)
- Revisions to the Basel II market risk framework - updated as of 31 December 2010 (February 2011)
- Basel III: A global regulatory framework for more resilient banks and banking systems - revised version (June 2011)
- Treatment of trade finance under the Basel capital framework (October 2011)
- Interpretive issues with respect to the revisions to the market risk framework (November 2011)
- Global systemically important banks: Assessment methodology and the additional loss absorbency requirement (November 2011)
- Basel III definition of capital - Frequently asked questions (update of FAQs published in October 2011)

## C. List of US organisations met during the on-site visit

### US regulatory agencies

- Office of the Comptroller of the Currency (OCC)
- Federal Reserve Board (FRB)
- Federal Deposit Insurance Corporation (FDIC)

### US banking industry associations

- American Bankers Association (ABA)
- Financial Services Roundtable (FSR)

## D. Data on US banking sector

Table 1

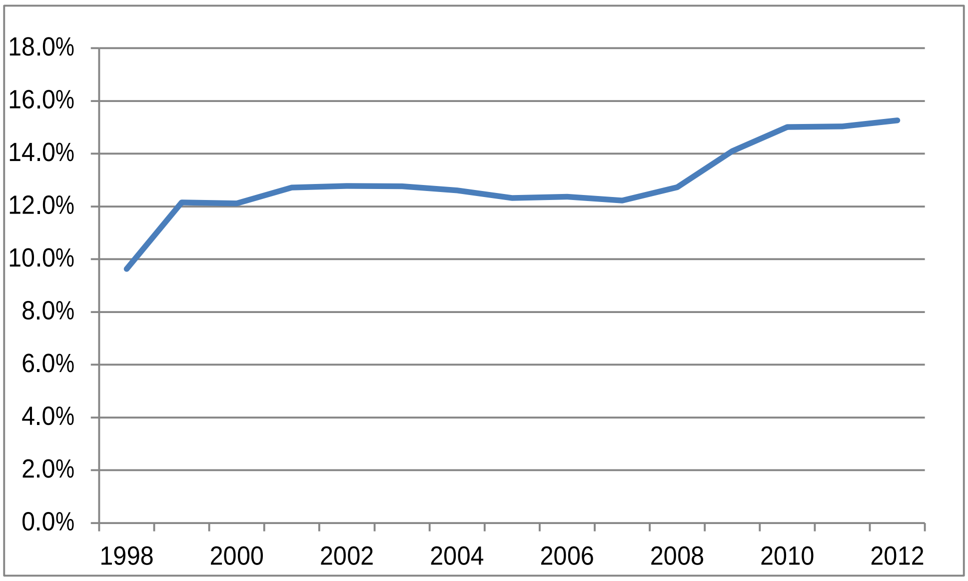
**Selected indicators of US banking sector**

| **Number of banks** | |
|---|---|
| Number of banks (depository institutions) | 6263 |
| Number of Global Systemically Important Banks (G-SIBs) | 8 |
| Number of core banks, required to implement Basel II | 17 |
| Number of opt-in banks | 1 |
| Number of banks that report having foreign assets | 41 |
| **Size of banking sector** | |
| Total assets all US banks (USD, bn) | 12780 |
| Total assets core banks (USD, bn) | 7115 |
| Total foreign assets core banks (USD, bn) | 1557 |
| Total assets all US banks as % of total assets US financial system | 26% |
| Total assets US core banks as % of total assets all US banks | 56% |
| Total foreign assets US core banks as % of total foreign assets all US banks | >95% |
| **Capital adequacy (all banks)** | |
| Total capital (USD, bn) | 1455 |
| Total Tier 1 capital (USD, bn) | 1114 |
| Total Tier 2 capital (USD, bn) | 202 |
| Total risk-weighted assets (USD, bn) | 8629 |
| Total capital ratio (weighted average) | 15.3% |
| Tier 1 ratio (weighted average) | 12.9% |
| **Capital adequacy (five largest US banks)** | |
| Total capital (USD, bn) | 714 |
| Total Tier 1 capital (USD, bn) | 576 |
| Total risk-weighted assets (USD, bn) | 4200 |
| Capital adequacy ratio (weighted average) | 17.1% |
| Tier 1 ratio (weighted average) | 13.8% |

*Sources*: calculations based on public information from OCC, FDIC, Federal Reserve Board and IMF. Where possible data is of end-March 2012, except for data on total financial system assets which is based on 2010 data (source: IMF).

**Figure 1**

Total capital ratio - all US banks

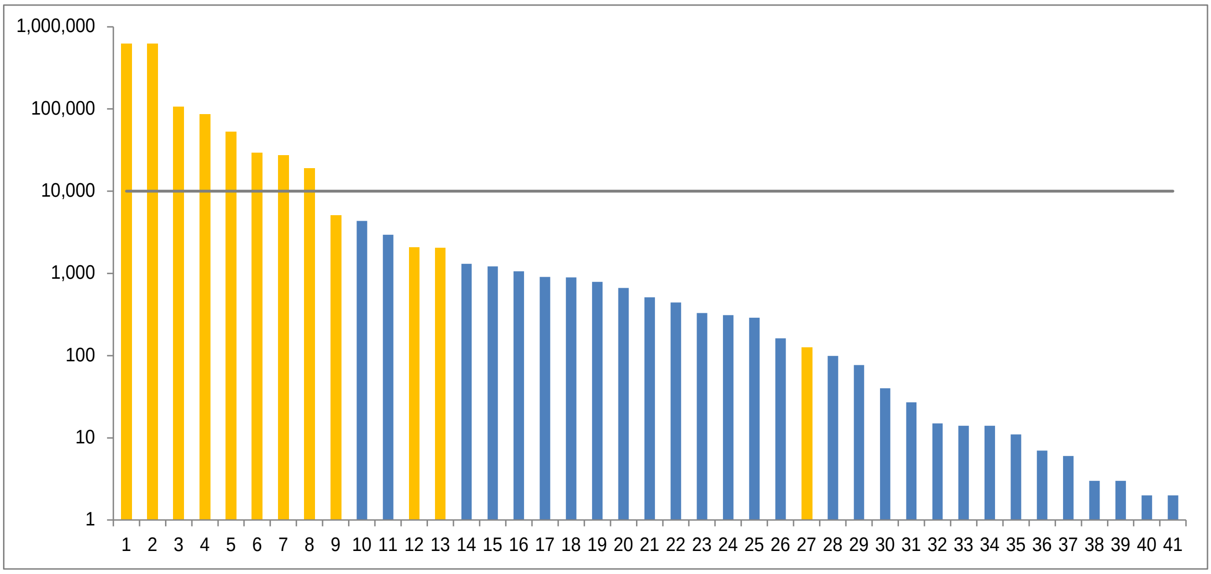



Note: weighted average of total capital ratios of US banks, based on the general risk-based capital rule.

Source: Own calculations based on public data from the FDIC

**Figure 2**

International assets held by US banks (USD million)




Note: more than 95% of the foreign assets held by US banks are on the balance sheet of core banks. Please note that the y-axis is in logarithmic scale, which makes large values appear relatively smaller. Each column represents a US bank. The banks are ranked according to the size of their international assets. The yellow bars are banks that are also a core bank according to the US definition. The horizontal line indicates the US threshold for international exposures above which a bank is considered a core bank that is required to implement the advanced Basel approaches (USD 10 billion).

Source: own calculations based on public data from the Federal Reserve Board

## E. Assessment of compliance with the minimum requirements to ensure loss absorbency at the point of non-viability (PON)

The United States have chosen the option of **statutory implementation** of the Basel III minimum requirements to ensure loss absorbency at the point of non-viability for non-common equity Tier 1 and Tier 2 capital instruments (PON – see BIS press release 13 Jan. 2011, Annex), which requires compliance with clauses (a), (b) and (c) of paragraph 1 of the Basel PON framework.

*Capital instruments issued by US-based banks and bank holding companies.* All seven paragraphs of the Basel III PON standards can be considered as consistent with the Basel PON standards if the triggers are implemented under receivership. Moreover, under US law, any capital injection to banks outside of receivership would require congressional approval. In the assessment team's view, this makes all non-common equity Tier 1 and Tier 2 instruments issued by US-based banks or bank holding companies compliant with the Basel PON standards.

*Capital instruments issued by non-US subsidiaries of US-based banks and bank holding companies.* To the extent that the US framework cannot be enforced outside of the United States, non-common equity Tier 1 and Tier 2 instruments issued by non-US subsidiaries of a US-based bank or bank holding company could not be recognised as regulatory capital at the group's consolidated level unless PON loss absorbency is implemented contractually in compliance with the Basel PON standards. However, no provisions have been issued or proposed to the effect that (i) such instruments would cease to qualify for recognition at the group's consolidated level, unless PON loss absorbency is implemented contractually in compliance with the Basel PON standards, and (ii) therefore need to be phased out in accordance with Basel III transitional arrangements for non-qualifying capital instruments.

As a consequence of the identified gap in US proposed regulations for the implementation of Basel III, US statutory implementation of PON loss absorbency is assessed as *Largely Compliant* with Basel III standards.

## Detailed assessment

### Paragraph 1 Clause (a)

This clause requires the governing jurisdiction of the bank to have in place laws that (i) require all non-common equity Tier 1 and Tier 2 instruments issued by an internationally active bank to be written off upon the occurrence of the trigger event (defined in paragraphs 2 and 6 of the Basel PON framework – discussed further below), or (ii) otherwise require such instruments to fully absorb losses before taxpayers are exposed to loss.

***Assessment:***

- The US approach is implemented under receivership. A summary is presented below of the main relevant aspects of the legal framework for receivership that apply in the US, respectively, to: (A) individual insured depository institutions (DIs) resolved under the Federal Deposit Insurance (FDI) Act; and (B) "covered financial companies" resolved under the Dodd-Frank Act Orderly Liquidation Authority (OLA).

***For individual insured DIs (FDI Act):***

- Among the grounds for putting an insured DI into receivership are any of the following, which can be interpreted as reaching the PON: (i) the institution is likely to be unable to pay its obligations or meet its depositors' demands in the normal course of business; (ii) the institution has incurred or is likely to incur losses that will deplete substantially all of its capital, and there is no reasonable prospect for it to become adequately capitalised without Federal assistance; (iii) the institutions is undercapitalised and has no reasonable prospect of becoming adequately capitalised, or is critically undercapitalised, or otherwise has substantially insufficient capital.
- Under receivership, payments of claims can be made either in cash or through transfer to a bridge DI or existing DI (see FDI Act Section 11 (d) (11) (A), (d) (2) (G), (f) (1) and (n) (3)). Correspondingly, losses can be imposed on holders of non-common equity Tier 1 or Tier 2 instruments by not transferring them to a bridge DI or to an existing DI, thus leaving them to be paid from any proceeds of the liquidation of the failed DI's residual balance sheet, where claims would be subject to the "payments waterfall" described immediately below.
- The FDI Act (12 USC § 1821(d) (11)) and FDIC regulations (12 CFR § 360.3 and 360.4) determine a "payments waterfall" under which subordinated debt instruments come next after equity instruments in absorbing losses before other creditors are affected.
- The FDI Act provides in section 11(d) broad resolution powers for the FDIC, including (in 11(d) (2) (A)) that the FDIC as conservator or receiver succeeds to all rights, titles, powers, and privileges of the insured DI, and of any stockholder, member, accountholder, depositor, office, or director of such institution with respect to the institution and the assets of the institution.
- The FDIC can provide to the bridge DI, if needed, operating funds in lieu of capital (FDI Act Section 11 (n) (5) (B)).
- The bridge DI can operate for up to 5 years (an initial 2-year period followed by the option of three 1-year extensions at the FDIC Board's discretion) under management appointed by the FDIC (FDI Act Section 11 (n) (9)).
- The bridge bank can be merged or consolidated with an existing DI, or its capital stock can be sold (FDI Act Section 11 (n) (10)).

***For covered financial companies (Dodd-Frank Act OLA):***

- According to Dodd-Frank Sections 202 and 203, "covered financial companies" are financial companies (FCs – which include bank holding companies, among others), excluding any insured DIs, for which, upon recommendation by the FDIC and the Fed,[19] the Secretary of the Treasury (in consultation with the President) has determined (according to 12 USC § 5383) that: (i) the FC is in default or in danger of default (defined in terms similar to those that constitute grounds for putting an insured DI into receivership under the FDI Act); (ii) the failure of the FC and its resolution under otherwise applicable law would have serious adverse effects on

[19] Where the financial company or its largest domestic subsidiary is a broker or dealer, the recommendation is made by the Fed and the Securities and Exchange Commission, in consultation with the FDIC. Where the financial company or its largest domestic subsidiary is an insurance company, the recommendation is made by the Fed and the Director of the Federal Insurance Office, in consultation with the FDIC.

financial stability in the United States; (iii) no viable private sector alternative is available to prevent the default; (iv) any effect on the claims or interests of creditors, counterparties, and shareholders of the FC and other market particpants are appropriate, given the impact that any action taken under Title II would have on financial stability; (v) any action taken would avoid or mitigate such adverse effect; (vi) a Federal regulatory agency has ordered the financial company to convert all of its convertible debt instruments that are subject to the regulatory order; and (vi) the company satisfies the definition of an FC in OLA.

- After the above determination and according to 12 USC § 5382, receivership procedures are initiated and the FDIC may be appointed as receiver.
- Under a receivership formed pursuant to Title II of the Dodd-Frank Act (similarly to the case of individual insured DIs under the FDI Act), payments of claims can be made either in cash or through transfer to a bridge FC or existing FC (see 12 USC § 5390(b) (1); (a) (1)(F) and (G); and (h) (5)). Correspondingly, losses can be imposed on holders of non-common equity Tier 1 or Tier 2 instruments by not transferring them to a bridge FC or to an existing FC, thus leaving them to be paid from any proceeds of the liquidation of the failed FC's residual balance sheet where claims would be subject to the priority of claims described below.
- OLA, section 206 (12 USC § 5386(2) and (3)) requires the FDIC as receiver to ensure that: (i) the shareholders do not receive payment until after all other claims and the Orderly Liquidation Fund are fully paid; and (ii) unsecured creditors bear losses in accordance with the priority of claims provisions in § 5390 (see below).
- The priority of claims is set forth section 210(b) (12 USC § 5390(b)) and clarified by FDIC regulations (12 CFR § 380.21 through 380.27). In particular, it establishes that unsecured claims of the United States (including those of FDIC) shall, at a minimum, have a higher priority than liabilities of the covered financial company that count as regulatory capital.
- OLA provides in section 210(a) broad resolution powers for the FDIC, including (in 12 USC § 5390(a)(1)(A)(i)) that the FDIC as receiver succeeds to all rights, titles, powers, and privileges of the covered financial company and its assets, and of any stockholder, member, office, or director of such company.
- OLA powers and authorities also mandate (in 12 USC § 5390(a)(1)(M)) that the FDIC as receiver shall ensure that shareholders and unsecured creditors bear losses, consistent with the priority of claims provisions under section 210(b) (see above).
- Section 214 of the Dodd-Frank Act provides that: (i) all financial companies put into receivership under OLA shall be liquidated and no taxpayer funds shall be used to prevent the liquidation of any financial company under OLA; (ii) all funds expended in the liquidation of a financial company under OLA shall be recovered from the disposition of assets of the company or through assessments to the financial sector; and (iii) taxpayers shall bear no losses from the exercise of any authority under OLA.
- The FDIC can provide to the bridge FC, if needed, operating funds in lieu of capital (12 USC § 5390(h)(2)(G)(iv) and (9); see also 12 USC §§ 5384(d) and 5390(n)(9)).
- The bridge FC can operate for up to 5 years (an initial 2-year period followed by the option of three 1-year extensions at the discretion of the FDIC) under management appointed by the FDIC (12 USC § 5390(h)(12)).
- The bridge FC can be merged or consolidated with an existing FC, or its capital stock can be sold (12 USC § 5390(h)(13)).

- As explained by FDIC lawyers to the assessment team, US implementation of bail-in under receivership implies that: (i) the failed financial company is closed; (ii) its license is withdrawn; and (iii) it is succeeded by a new legal entity created under receivership procedures. Moreover, it was explained that all of the above procedures, including the requisite authorisations beyond the FDIC, can be implemented rapidly (“over a weekend”).

*Conclusion:* Since putting an insured DI or a covered FC into receivership implies the determination that the company has reached the PON without the write-off of all or part of non-common equity Tier 1 and Tier 2 instruments, since the FDIC has the power to impose such write-off, and since the law requires such instruments to absorb losses immediately after common equity instruments before imposing losses on other creditors, the joint effect of all of the above is to require non-common equity Tier 1 and Tier 2 instruments issued by an internationally active bank to be written off upon occurrence of the Basel III PON trigger event to the extent needed, if the decision is taken to put the institution into receivership.

**Paragraph 1 Clause (b)**

This clause requires a peer group review to confirm that the jurisdiction conforms to clause (a). The current peer review addresses this requirement.

**Paragraph 1 Clause (c)**

This clause requires the relevant regulator and the issuing bank to disclose, in issuance documents going forward, that such instruments are subject to loss under clause (a).

***Assessment:***

- The Basel III NPR in para 20(c)(1)(xiv) and (d)(1)(xi) establishes that, “For an advanced approaches [BANK], the governing agreement, offering circular, or prospectus issued after January 1, 2013 must disclose that the holders of the instrument may be fully subordinated to interests held by the U.S. government in the event that the [BANK] enters receivership, insolvency, liquidation, or similar proceeding.”
- Moreover, the legal provisions establishing such subordination (discussed above for clause (a)) are known to the public.

*Conclusion:* The disclosure requirement in clause (c) is fulfilled.

**Paragraph 2**

This paragraph requires that any compensation paid to the instrument holders as a result of the write-off must be paid immediately in the form of common stock (or its equivalent in the case of non-joint stock companies).

***Assessment:***

- Under receivership and closed-bank resolution, the issue of compensating holders of non-common equity Tier 1 or Tier 2 instruments does not arise. Either all or part of their claim may be transferred to the bridge bank as a liability (if enough good assets are available in the failed bank), or their claims will remain in the failed bank’s residual balance sheet to be paid out from the liquidation proceeds.

*Conclusion:* Paragraph 2 is not applicable in the US case of statutory implementation of PON loss absorbency.

### Paragraph 3

This paragraph requires the issuing bank to maintain at all times all prior authorisation necessary to immediately issue the relevant number of shares specified in the instrument's terms and conditions should the trigger event occur.

***Assessment:***

- As discussed above, under receivership and closed-bank resolution, the issue of compensating holders of non-common equity Tier 1 or Tier 2 instruments does not arise.
- In any case, the authorisation to issue common stock is provided to the FDIC in both the FDIC Act and in Dodd-Frank OLA: (i) as successor to the failed insured DI or FC; or (ii) as organiser of a bridge DI or FC that assumes assets and liabilities of the covered financial company subject to receivership and/or succeeds to the latter's rights and privileges.

*Conclusion:* Paragraph 3 is fulfilled or not applicable in the US case of statutory implementation of PON loss absorbency.

### Paragraph 4

This paragraph defines the trigger event as the earlier of: (1) a decision that a write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority; and (2) the decision to make a public sector injection of capital, or equivalent support, without which the firm would have become non-viable, as determined by the relevant authority.

***Assessment:***

- Trigger (1) above can be implemented in the US in receivership under the FDI Act or under OLA.
- Trigger (2) is excluded in the US, in receivership, by the Dodd-Frank OLA prohibition on taxpayer funding in section 214. Outside of receivership, trigger (2) would not be possible without congressional approval.

*Conclusion:* Paragraph 4 is fulfilled.

### Paragraph 5

This paragraph requires that the issuance of any new shares as a result of the trigger event must occur prior to any public sector injection of capital so that the capital provided by the public sector is not diluted.

***Assessment:***

- Public sector injection of capital is excluded in the US, in receivership, by the Dodd-Frank OLA prohibition on taxpayer funding in section 214. Outside of receivership, public sector injection of capital would not be possible without congressional approval.

*Conclusion:* Paragraph 5 is fulfilled.

### Paragraph 6

This paragraph defines an additional trigger event in the case where an issuing bank is part of a wider banking group and the issuing bank wishes the instrument to be included in the consolidated group's capital. This trigger event is the earlier of: (1) a decision that a write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority in the home jurisdiction; and (2) the decision to make a public sector injection of capital, or equivalent support, in the jurisdiction of the consolidated supervisor, without which the firm receiving the support would have become non-viable, as determined by the relevant authority in that jurisdiction.

***Assessment:***

- Neither trigger (1) nor trigger (2) would have any cross-border effects: FDI Act and OLA resolution powers do not have a cross-border reach and could not be used to impose losses on holders of instruments issued by a non-US subsidiary of the banking group. The limitation on the cross-border application of trigger (1) would seem to be inherent to any statutory implementation of the PON Basel framework.

*Conclusion:* Non-common equity Tier 1 and Tier 2 instruments issued by non-US subsidiaries of a US-based banking group could not be recognised as regulatory capital at the group's consolidated level unless PON loss absorbency is implemented contractually in compliance with the Basel PON standards. No provisions have been issued or proposed to the effect that such instruments would cease to qualify for recognition at the group's consolidated level, unless PON loss absorbency is implemented contractually in compliance with the Basel PON standards.

### Paragraph 7

This paragraph requires that any common stock paid as compensation to the holders of the instrument must be common stock of either the issuing bank or of the parent company of the consolidated group (including any successor in resolution).

***Assessment:***

- Given the above assessment of paragraph 6, non-common equity Tier 1 and Tier 2 instruments issued by non-US subsidiaries of a US-based banking group could not be recognised as regulatory capital at the group's consolidated level unless PON loss absorbency is implemented contractually in compliance with the Basel PON standards.
- Moreover (as for paragraph 2), under receivership and closed-bank resolution, the issue of compensating holders of non-common equity Tier 1 or Tier 2 instruments does not arise. Either all or part of their claim may be transferred to the bridge bank as a liability (if enough good assets are available in the failed bank), or their claims will remain in the failed bank's residual balance sheet to be paid out from the liquidation proceeds.

*Conclusion:* Paragraph 7 is not applicable in the US case of statutory implementation of PON loss absorbency.

***Transitional arrangements***

According to the Basel III PON standards, instruments issued on or after 1 January 2013 must meet the criteria set out in paragraphs 1 through 7 to be included in regulatory capital. Instruments issued prior to 1 January 2013 that do not meet the criteria set out above, but that meet all of the entry criteria for Additional Tier 1 or Tier 2 capital set out in *Basel III: A global regulatory framework for more resilient banks and banking systems*, will be considered as an "instrument that no longer qualifies as Additional Tier 1 or Tier 2" and will be phased out from 1 January 2013 according to paragraph 94(g).

***Assessment:***

- Regarding paragraph 6, Basel III-compliant transitional arrangements would be needed for phasing out the recognition as regulatory capital at the group's consolidated level of non-common equity Tier 1 and Tier 2 instruments issued by non-US subsidiaries of a US-based banking group, unless PON loss absorbency is implemented contractually for such instruments in compliance with the Basel III PON standards.

*Conclusion:* The US implementation of Basel III transitional arrangements needs to be clarified in the sense that the recognition as regulatory capital at the group's consolidated level of non-common equity Tier 1 and Tier 2 instruments issued by non-US subsidiaries of US-based banks or bank holding companies, for which instruments PON loss absorbency is not implemented contractually in compliance with the Basel III PON standards, will be phased out according to the same schedule applicable to all instruments that no longer qualify as Additional Tier 1 or Tier 2.

## F. List of issues for follow-up assessment

The assessment team has listed the following findings for the follow-up materiality assessment. Typically, these findings could not be assessed quantitatively or there was not sufficient data available to complete the materiality assessment, while the assessment team judges these finding as potentially material. The follow-up assessment will take place once the final rule on the implementation of Basel III is published.

List of issues for follow-up assessment:

- The treatment of insurance entities in the definition of capital
- The treatment of capital instruments issued by non-US subsidiaries of US-based banks, which no longer qualify as Additional Tier 1 or Tier 2 under the PON framework
- The treatment of defined benefit pension fund assets
- The treatment of financial collateral (not being sovereign paper) with a rating lower than BBB- or that is an unrated security issued by a nonbank organisation or a non-eligible unrated bank security
- The absence of the requirement to deduct the materiality threshold for eligible credit derivatives
- The treatment of Qualifying Revolving Retail Exposures (QRRE)
- The absence of a capital charge for dilution risk
- The capital treatment of defaulted exposures
- The capital requirements of the US simplified supervisory formula approach (SSFA) for securitisation positions, in comparison with the Basel approaches
- The treatment of specific wrong-way risk for counterparty credit risk
- The transitional period for the specific risk capital charge for securitisation instruments excluded from the correlation trading portfolio

## G. Statement by the US agencies on areas of super-equivalence

The US regulatory agencies have listed the following areas as super-equivalent compared to the Basel Framework. These statements have not been assessed by the assessment team.

- RW floor under SSFA (and US SFA) is 20% versus 7% under Basel standards.
- RW for exposures to wholesale obligors and exposures of retail segments is 8% (can be zero % under Basel standards.)
- For recognition of debt instruments as collateral for credit risk mitigation purposes, the U.S. rules require banks to evaluate whether the issuer is investment grade. In determining whether a debt security is investment grade, a bank must consider a variety of factors, including available external credit ratings, market data such as credit default swap spreads, financial information published by the issuer of the debt instrument, external credit assessments other than credit ratings, and internal analysis. A bank would have a greater burden to support its determination that a debt security is investment grade if one factor is contradicted by another factor. Hence, an investment grade credit rating for a particular debt security does not necessarily mean that the bank can recognise the security as collateral for credit risk mitigation purposes under changes proposed to the US advanced approaches rules
- U.S. proposed advanced approaches rules apply a 25% standard supervisory market price volatility haircut to all collateral in the form of non-sovereign debt securities that receive a 100% risk weight under the proposed U.S. standardised approach versus a haircut ranging from 1.0% for non-sovereign debt securities rated AAA to 12.0% for non-sovereign debt securities rated BBB- under the Basel standards.