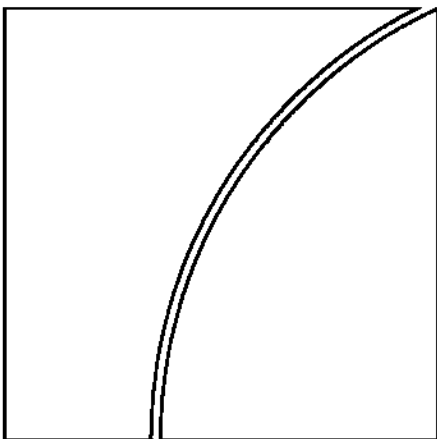


Basel Committee  
on Banking Supervision



Report to G20 Leaders on  
Basel III implementation

June 2012



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## Introduction and summary

At their 2010 summit in Seoul, the G20 Leaders endorsed the Basel III regulatory framework<sup>1</sup> as follows:

*“We endorsed the landmark agreement reached by the BCBS on the new bank capital and liquidity framework, which increases the resilience of the global banking system by raising the quality, quantity and international consistency of bank capital and liquidity, constrains the build-up of leverage and maturity mismatches, and introduces capital buffers above the minimum requirements that can be drawn upon in bad times.”<sup>2</sup>*

In November 2011, the Leaders, at their summit in Cannes, emphasised the importance of implementing Basel III:

*“We are committed to improve banks’ resilience to financial and economic shocks. Building on progress made to date, we call on jurisdictions to meet their commitment to implement fully and consistently the Basel II risk-based framework as well as the Basel II-5 additional requirements on market activities and securitisation by end 2011 and the Basel III capital and liquidity standards, while respecting observation periods and review clauses, starting in 2013 and completing full implementation by 1 January 2019.”<sup>3</sup>*

This interim report details the progress the members of the Basel Committee on Banking Supervision<sup>4</sup> have made to date in implementing the Basel III regulatory framework (including Basel II<sup>5</sup> and Basel 2.5,<sup>6</sup> which now form integral parts of Basel III). The report also describes various implementation issues identified through the comprehensive process the Committee has adopted to monitor members’ implementation of Basel III.

Compared to the status at end-September 2011 and end-March 2012, when the Committee published previous reports, significant progress has been observed. However, there are jurisdictions which have missed the globally-agreed implementation dates for Basel II and 2.5. There are also jurisdictions that have not made enough progress to date on Basel III and thus pose concern as to their ability to meet the agreed Basel III implementation date.

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<sup>1</sup> *Basel III: A global regulatory framework for more resilient banks and banking systems*, December 2010, [www.bis.org/publ/bcbs189.pdf](http://www.bis.org/publ/bcbs189.pdf) and *Basel III: International framework for liquidity risk measurement, standards and monitoring*, December 2010, [www.bis.org/publ/bcbs188.htm](http://www.bis.org/publ/bcbs188.htm)

<sup>2</sup> Seoul G20 Summit document

<sup>3</sup> Cannes G20 Summit document

<sup>4</sup> The Basel Committee on Banking Supervision consists of senior representatives of bank supervisory authorities and central banks from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The Committee’s governing body is the Group of Central Bank Governors and Heads of Supervision, which is comprised of central bank governors and (non-central bank) heads of supervision from member countries. The Committee usually meets at the Bank for International Settlements (BIS) in Basel, Switzerland, where its permanent Secretariat is located.

<sup>5</sup> *Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework*, June 2006, [www.bis.org/publ/bcbs128.pdf](http://www.bis.org/publ/bcbs128.pdf)

<sup>6</sup> *Enhancements to the Basel II framework*, July 2009, [www.bis.org/publ/bcbs157.pdf](http://www.bis.org/publ/bcbs157.pdf)

As of end-May 2012, 21 of 27 Basel member countries have implemented Basel II, which had been due to come into force from end-2006. In addition, Indonesia and Russia have implemented Basel II's Pillar 1 (minimum capital requirements). Argentina, China, Turkey and the United States are in the process of implementing Basel II.

With regard to Basel 2.5, which was due to be implemented from end 2011, 20 member countries have final rules that are in force. Argentina, Indonesia, Mexico, Russia, Turkey and the United States have not issued final regulations. Russia and the United States have issued draft regulations which partially cover Basel 2.5. Saudi Arabia has issued final regulations but these have not yet come into force. Among the 29 global systemically important banks (G-SIBs) identified in November 2011, nine are headquartered in jurisdictions that have not yet fully implemented Basel II and/or Basel 2.5.

Draft Basel III regulations have not yet been issued by seven Basel Committee member jurisdictions: Argentina, Hong Kong SAR, Indonesia, Korea, Russia, Turkey and the United States.<sup>7</sup> The majority of these jurisdictions believe they can issue final regulations in time to implement by the deadline of 1 January 2013. However, for others, depending on their domestic rule-making process, meeting the deadline could be a significant challenge.

In addition to monitoring whether its members have issued regulations to implement the Basel III rules, the Basel Committee has established a process to review the content of the new rules. This second level of review is meant to ensure that the national adaptations of Basel III are consistent with the minimum standards agreed to under Basel III. The Basel Committee has initiated peer reviews of the domestic regulations of the European Union, Japan and the United States to assess their consistency with the globally agreed standards. The findings of these reviews are preliminary since the formulation of national standards is still ongoing and the analysis is not yet completed. Nevertheless, there is a possibility that national implementation will be weaker than the globally-agreed standards in some key areas.

The Basel Committee urges G20 Leaders to call on jurisdictions to meet their commitments made in Cannes to implement Basel III fully and consistently, and within the agreed timetable.

A third level of implementation review conducted by the Basel Committee examines whether there are unjustifiable inconsistencies in risk measurement approaches across banks and jurisdictions and the implications these might have for the calculation of regulatory capital. This review of banks' risk-weighting practices includes the use of test portfolio exercises, horizontal reviews of practices across banks and jurisdictions, and joint on-site visits to large, internationally-active banks.

The Basel Committee firmly believes that full, timely and consistent implementation of Basel III among its members is essential for restoring confidence in the regulatory framework for banks and to help ensure a safe and stable global banking system. The Committee will provide an updated progress report to G20 Finance Ministers and central bank governors at their meeting in November 2012. That report will provide (i) an update on Basel Committee members' domestic rule-making, (ii) the final outcome of the regulatory consistency assessment of the European Union, Japan and the United States, and (iii) preliminary findings from the Committee's deeper analysis on banks' risk measurement approaches and regulatory capital calculations.

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<sup>7</sup> On 7 June, the Federal Reserve's Board of Governors published draft Basel III regulations, and these will be considered also by the FDIC and OCC in June 2012.



This interim report is based on the information that was available to the Basel Committee on 31 May 2012. Subsequent to this date, further information has become available in both the EU and US but there has been insufficient time to assess whether these latest developments are compliant with the Basel text for this interim report.

## Basel standards

In June 2004, a package of reforms known as Basel II introduced more risk-sensitive minimum capital requirements for banks, including an enhanced measurement of credit risk, and capture of operational risk. Basel II also reinforced the requirements by setting out principles for banks to assess the adequacy of their capital and for supervisors to review such assessments to ensure banks have the necessary capital to support their risks. It also strengthened market discipline by enhancing transparency in banks' financial reporting. The deadline for implementation of the Basel II framework by member jurisdictions was the end of 2006.<sup>8</sup>

In July 2009, enhancements to the measurement of risks related to securitisation and trading book exposures were agreed in response to early lessons from the 2007/08 crisis. An implementation deadline of the end of 2011 was set for these reforms, referred to as Basel 2.5.

In December 2010, the Basel Committee published Basel III, a comprehensive set of reforms to raise the resilience of banks. Basel III addresses both firm-specific and broader, systemic risks by:

- Raising the *quality* of capital, with a focus on common equity, and the *quantity* to ensure banks are better able to absorb losses;
- Enhancing the coverage of risk, in particular for capital market activities;
- Introducing additional capital buffers for the most systemically important institutions to address the issue of "too big to fail";
- Introducing an internationally harmonised leverage ratio to serve as a backstop to the risk-based capital measure and to contain the build-up of excessive leverage in the system;
- Stronger standards for supervision (Pillar 2), public disclosures (Pillar 3), and risk management;
- Introducing minimum global liquidity standards to improve banks' resilience to acute short term stress and to improve longer term funding; and
- Introducing capital buffers which should be built up in good times so that they can be drawn down during periods of stress.

The implementation period starts from 1 January 2013 and includes transitional arrangements until 1 January 2019. The transitional arrangements are available to give banks time to meet the higher standards, while still supporting lending to the economy.

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<sup>8</sup> With the exception of the most advanced approaches which were expected to be made available from the end of 2007.

The liquidity requirements, leverage ratio and systemic surcharges come into force on a phased approach starting from 2015 and will, therefore, be assessed later<sup>9</sup> and are not covered in this report.

## **Design of the Committee's Basel III Implementation Review Programme**

In January 2012, the Group of Central Bank Governors and Heads of Supervision (GHOS), the Basel Committee's oversight body, endorsed the comprehensive process proposed by the Committee to monitor members' implementation of Basel III. The process consists of the following three levels of review:

- Level 1: ensuring the timely adoption of Basel III;
- Level 2: ensuring regulatory consistency with Basel III; and
- Level 3: ensuring consistency of outcomes (initially focusing on risk-weighted assets).

The Basel Committee has published two "Level 1" progress reports.<sup>10</sup> It has agreed on a detailed "Level 2" assessment process and started reviews of the European Union, Japan and the United States. Its "Level 3" reviews analyse existing data on risk measured by banks' models and are designing processes for deeper analysis.

The Basel Committee has worked in close collaboration with the Financial Stability Board (FSB) given the FSB's role in coordinating the monitoring of implementation of regulatory reforms. The Committee designed its programme to be consistent with the FSB's Coordination Framework for Monitoring the Implementation of Financial Reforms (CFIM) agreed by the G20.

The objectives and the process of each of the three levels of review are as follows.

### **Level 1: Timely adoption of Basel III**

The objective of the "Level 1" assessment is to ensure that Basel III is transformed into domestic regulations according to the agreed international timelines. It does not include the review of the content or substance of the domestic rules. Each Basel Committee member jurisdiction's status is reported in a simple table.

Separately, the Financial Stability Institute (FSI) of the Bank for International Settlements is surveying non-Basel Committee member countries. The outcome of this work will be published by the FSI in the coming months.

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<sup>9</sup> To be included after the Committee concludes its review on any revisions or final adjustments

<sup>10</sup> *Progress report on Basel III implementation*, October 2011 and April 2012, [www.bis.org/publ/bcbs203.htm](http://www.bis.org/publ/bcbs203.htm), [www.bis.org/publ/bcbs215.htm](http://www.bis.org/publ/bcbs215.htm).

## **Level 2: Regulatory consistency**

The objective of the “Level 2” assessments is to ensure compliance of domestic regulations with the international minimum requirements. Delays or failures to adopt domestic regulations identified by the Level 1 review will feed into the Level 2 assessment.

All Level 2 assessments will be summarised using the following four-grade scale: compliant, largely compliant, materially non-compliant and non-compliant. The Committee intends to produce an overall assessment, as well as assessments of the main components of Basel III.

All Basel Committee member countries will be assessed over time. The Committee decided to prioritise its reviews, focusing first on the home jurisdictions of global systemically important banks (G-SIBs). The first reviews commenced in February 2012 with the European Union, Japan and the United States.

A summary of the process for the Level 2 reviews is included in appendix 2 of this report.

## **Level 3: Risk-weighted assets consistency**

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 findings of Levels 1 and 2, both of which focus on national rules and regulations, to supervisory implementation at the bank level.

The Committee has established two expert groups, one on the banking book and the other on the trading book. These groups will identify areas of material inconsistencies in the calculation of risk-weighted assets (RWAs, or the denominator of the Basel capital ratio). Depending on the outcome, the work may result in policy recommendations to address identified inconsistencies.

## **Preliminary findings**

### **Level 1**

The tables in appendix 1 show member countries’ implementation status as of end-May 2012. The tables use the following number codes:

- “1” for draft regulation not published,
- “2” for draft regulation published,
- “3” for final rule published, and
- “4” for final rule in force.

Summary information about the next steps and the implementation plans being considered by members are also provided for each jurisdiction. Separate tables are produced for each of Basel II, Basel 2.5 and Basel III. For Basel II and 2.5, which should be implemented already according to the agreed timetable, countries that have fully implemented are shown in green; those in the process of implementing are shown in yellow; and those that have not yet issued draft regulations are shown in red.

Compared to the status at end-September 2011 and end-March 2012, when the Committee published previous reports, significant progress has been observed. However, there are jurisdictions which have missed the globally-agreed implementation dates for Basel II and

2.5. There are also jurisdictions that have not made enough progress to date on Basel III and thus pose concern as to their ability to meet the agreed Basel III implementation date.

### **Basel II**

Three-quarters of member countries have implemented the Basel II requirements. Of the remaining six countries, Indonesia and Russia have implemented Pillar 1 (minimum capital requirements) but not Pillar 2 (supervisory review process) or Pillar 3 (disclosure and market discipline). Turkey expects to be fully compliant by July 2012. China has issued final regulations and is currently assessing applications for advanced approaches submitted by large banks. The United States is in “parallel run” (ie running both Basel I and Basel II calculation for its largest banks), although Basel I rules remain the legal minimum. Argentina implemented rules on operational risk in April 2012.

### **Basel 2.5**

Again, a majority of Basel Committee member countries (20 out of 27 Basel Committee members) have implemented the requirements, but a significant minority are either still in the process of implementation or have not started the process for implementation. Russia and the United States have issued draft regulations covering the market risk elements of the enhancements. The US regulations were modified in December 2011 to incorporate restrictions on the use of credit ratings as set forth in the Dodd-Frank regulatory reform legislation.<sup>11</sup>

Other member countries which have not implemented Basel 2.5 are Argentina, Indonesia, Mexico, Saudi Arabia and Turkey.

### **Basel III**

Three countries – India, Japan<sup>12</sup> and Saudi Arabia – have published final regulations necessary for implementing the Basel III package from 1 January 2013. Full application starts in Japan at the end of March 2013 to match Japanese banks’ fiscal year end.

The European Union has published several rounds of draft directives and regulations (CRD4/CRR)<sup>13</sup> and is expecting to have final rules by the end of June. The EU level regulations implement most elements of the Basel III package directly. This means there is no need for national regulations to transpose the regulations into their domestic legislation.

The following seven member jurisdictions have not issued draft regulations: Argentina, Hong Kong SAR, Indonesia, Korea, Russia, Turkey and the United States.<sup>14</sup> The majority of these countries believe they can finalise regulations in time for the agreed start date of 1 January

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<sup>11</sup> Final regulations for the market risk elements of Basel 2.5 were published by the Federal Reserve’s Board of Governors on 7 June 2012, and these will be considered by the FDIC and OCC also in June 2012.

<sup>12</sup> Japan’s final regulations do not include capital buffers which come into force from 2016.

<sup>13</sup> The European Union has published several rounds of its draft fourth Capital Requirements Directive (CRD4) and Capital Requirements Regulations (CRR) for implementing Basel III and expects to publish final rules by end June 2012

<sup>14</sup> On 7 June, the Federal Reserve’s Board of Governors published draft Basel III rules, and these will be considered also by the FDIC and OCC in June 2012.

2013. However, for others, depending on the domestic rule-making process, meeting the deadline could be a significant challenge.

## **Level 2**

The first three Basel III regulatory consistency assessments are currently under way for the European Union, Japan and the United States, which are being conducted in parallel.

In the initial phase of the Level 2 assessment process, the jurisdictions have been asked to complete a detailed self-assessment questionnaire and to provide all components of the regulations that implement Basel III at the domestic level. After receiving the completed questionnaires, peer review teams of supervisors have reviewed the completed self assessment and drafted an initial list of preliminary findings. The European Union, Japan and the United States are at different stages of Basel III implementation. Given these differences, the depth of the preliminary Level 2 findings differs.

**The reviews are still work in progress and this interim report is based solely on preliminary findings that are subject to further review as the analysis progresses.**

Currently, the peer review teams are in the process of further analysing the preliminary findings based on additional clarifications that were received from the jurisdictions concerned. The review teams are also working on the assessment of the potential materiality of their findings, using quantitative bank-specific data that was provided by the authorities. An important element in the second phase of the assessment will be an on-site visit where the teams will discuss their findings with the authorities to further narrow down the materiality of the findings to arrive at a final assessment. The on-site visits are tentatively scheduled in June and July. The final report is expected to be submitted to the Basel Committee in September 2012, and will be published shortly thereafter.

The absence of any item among the topics mentioned above does not necessarily mean that the review team will not add new items to the list of issues for further investigation during the progress towards the final report.

## ***European Union***

The review of the European Union (EU) rules related to Basel III has been complicated by the absence of a stable EU text implementing Basel III. As a pragmatic choice, the review team<sup>15</sup> selected the Third Danish Presidency Compromise proposals<sup>16</sup> for the basis of this interim report. This choice does not imply any endorsement by the assessment team of these proposals, but simply responds to the need to use the most recent draft such that the text remains stable for the time required to complete the interim review.

**At the time this interim report was prepared, the final version of CRD4/CRR – the rules for implementing Basel III in the European Union – were not yet published. Therefore**

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<sup>15</sup> The Level 2 assessment of the EU is comprised of a team of experts led by Mr Charles Littrell (Australian Prudential Regulation Authority). The review team comprises: Mr Sergio Andenmatten (Swiss Financial Market Supervisory Authority), Ms Margaret Griffin (Reserve Bank of New Zealand), Ms Anna Lee Hewko (Federal Reserve Board), Ms Sandy Ho (Monetary Authority of Singapore), Mr Satoshi Ikeda (Financial Services Agency of Japan), and Mr Rajinder Kumar (Reserve Bank of India). The team is supported by Mr Juan-Carlos Crisanto of the Basel Committee Secretariat.

<sup>16</sup> Council of the European Union, *Proposals for a Directive and Regulation of the European Parliament and of the Council - Presidency Compromises*, 2 April 2012.

**the number and nature of the findings set out in the Basel Committee's final report may change substantially from those contained in this interim report to the extent that the final CRD4/CRR rules differ from the Third Danish Compromise proposals.<sup>17</sup>**

Besides the changing nature of the EU proposals, the assessment has also been difficult due to the particularities of the EU rule-making process. This meant that the European Commission (EC) was unable to complete the requested self-assessment questionnaire, beyond mapping the Basel framework to the July 2011 EC proposals and providing explanatory notes on the compliance of key areas of the EU regulation with Basel III<sup>18</sup>. Unlike the other assessments, which have benefited from country self-assessments, the EU review team has not been able to draw on a comprehensive self-assessment from which to begin its assessment process.

Despite these difficulties, the review team conducted a detailed preliminary assessment of the EU framework. This assessment benefited from face-to-face discussions between the leader of the review team and EC staff as well as with representatives from the European Banking Authority, the European Central Bank, the Danish Presidency, and the nine EU countries which are also BCBS members.

### *Preliminary findings*

The initial assessment process has identified a large number of features of the current EU Basel III proposals that will require further investigation. Most of these issues will probably prove either consistent with the Basel framework, or immaterial in practice. There seems to be a small number of issues, however, that are potentially material and will need to be subject to a detailed assessment by the review team.

The EU framework has been developed with the principle of "maximum harmonisation." This is designed with the aim of achieving a high level of harmonisation of banking rules and limiting divergence between the approaches taken by individual national authorities. While not a matter of direct relevance to the assessment in the first instance, the ability for an individual national regulator to comply with Basel III where EU regulation is found to be inconsistent will depend on the degree of "maximum harmonisation" at the EU level. In this case, it may work to limit the room an individual regulator has to adopt compliant regulations on its own.

The review team has identified the following specific areas of potential difference. These areas require further review and/or an assessment of their potential materiality before definitive conclusions can be drawn:

### *Definition of Capital*

There are three specific issues that warrant particular attention:

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<sup>17</sup> More recently, the EU has published a Fifth Danish Compromise text, EU Parliamentary proposals and the EC's Framework for the recovery and resolution of credit institutions and investment firms. The review team has not had time to assess whether these latest developments are compliant with the Basel text for the interim report, rather these and/or and subsequent texts will form part of the final assessment

<sup>18</sup> Explanatory notes were provided on the permanent partial use of the zero risk weight for sovereigns; consolidation of insurers; capital definition based on 14 criteria without the name "common shares"; the consequence of the single rule book for countries' flexibility; treatment of banks' investments in insurance companies; and the impact of national macro-prudential flexibility on both Home and Host Member States in the internal market context

- The Basel III rules require banks to deduct significant investments in unconsolidated financial entities, including insurance entities, from the highest quality form of capital (Common Equity Tier 1 – CET1). The CRD IV/CRR proposals give competent authorities the possibility to permit banks not to deduct insurance holdings under certain conditions. The review team will need to assess whether the CRD IV/CRR proposals are consistent with the Basel requirements that only permit approaches other than deduction where it can be demonstrated that these are more conservative (ie would produce higher capital requirements) than the deduction approach.
- The Basel III rules are explicit that for joint stock companies, only common shares, which comply with a list of substantive criteria, can be included in CET1. However, the CRD IV/CRR proposals recognise any capital instrument, which satisfies a list of substantive criteria in line with Basel III, as part of CET1 even if they might not be common shares. The review team will need to evaluate whether this deviation from Basel III has the potential to undermine the quality of capital that banks should have to absorb losses.
- Basel III requires that all classes of capital instruments fully absorb losses at the point of non-viability before taxpayers are exposed to loss.<sup>19</sup> This requirement has been acknowledged in the CRD IV/CRR proposals<sup>20</sup> but not reflected according to the Basel rules. Going forward, the review team will closely monitor how this requirement is being reflected in the EU regulations, including within the forthcoming EU resolution and crisis management rules.

#### *Pillar 1: Credit Risk – Internal Ratings-Based (IRB) Approach*

Under the Basel rules, a bank electing to use an internal model to calculate its regulatory capital requirements for credit risk (IRB Bank) may only permanently apply the standardised approach for non-significant or immaterial business units or asset classes (referred to as the “partial use exemption”). The CRD IV/CRR framework allows IRB banks to permanently use the standardised approach for some exposures under certain conditions that might not appear to be related to the immateriality or non-significance described above. In particular, an IRB Bank in the EU is able to permanently apply a zero risk weight to EU sovereign exposures after receiving the permission of the competent authorities. The review team will need to further analyse the consistency of the CRD IV/CRR framework with the Basel rules regarding the permanent partial use available to IRB Banks, with special focus on internationally active banks’ sovereign exposures.

#### *Next steps*

The review team’s key focus going forward will be to resolve consistency issues, and assess the materiality of any inconsistency. The latter will be mainly based on bank-specific data. The nine EU member countries of the Basel Committee have undertaken to assist with securing the data that will be needed for the materiality assessment.

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<sup>19</sup> Final elements of the reforms to raise the quality of regulatory capital issued by the Basel Committee, January 2011, [www.bis.org/press/p110113.htm](http://www.bis.org/press/p110113.htm)

<sup>20</sup> Recital 27 in Council of the European Union, *Proposal for a regulation of the European Parliament and of the Council*, - Presidency Compromise, 2 April 2012.

## **Response from the European Commission**

Two preliminary points need to be made. First, from the point of view of banking regulation, the European Union (EU) is a single jurisdiction: laws adopted at EU level are agreed by, and apply to, all EU Member States. Second, the EU has chosen to apply the Basel rules to all its banks (as well to investment firms), not just large, internationally active banks; the law therefore needs to allow national authorities to exercise a certain level of proportionality in applying the rules.

The first point is particularly important with respect to the “maximum harmonisation” principle referred to in the report.<sup>21</sup> In this context, the assessment fails to provide valid arguments on why the degree of harmonisation pursued in the EU could be considered an issue for any of the specific areas of potential difference mentioned in the report.

The second point is relevant to all the specific issues listed in the report. For example, the possibility for IRB banks to permanently use the standardised approach for certain exposures was never meant to be used for internationally active banks and supervisors were (and will continue to be) expected not to approve it for those banks.

Concerning the specific issues, there are some additional points. Firstly, the proposed approach on significant investments in insurance reflects the existence of strict and harmonised rules for insurance and financial conglomerates at EU level, takes into account the recently revised Joint Forum's principles for financial conglomerates supervision, provides appropriate incentives for insurance companies' capitalisation and prevents double counting of capital. The assessment should take these facts into account.

Secondly, the concept of common shares does not exist in a large number of EU Member States, which explains the choice of approach based on the characteristics of capital instruments, rather than their form. Nevertheless, publicly listed banks are expected to meet their CET1 requirement only with shares meeting the 14 criteria. Furthermore, specific monitoring powers have been conferred upon the European Banking Authority in order to identify any misuse of this approach by banks.

Lastly, the European Commission expects to adopt legislation implementing the point-of-non-viability requirement before summer of this year.

## **Japan**

By end March 2012, the Japanese authorities published final rules implementing Basel III with respect to the definition of capital and risk-weighted assets (RWA), while the Basel II and Basel 2.5 regulation had already been transposed into domestic rules previously. The documents for the Japan Level 2 review include notices, supervisory guidelines, inspection manuals and Qs and As<sup>22</sup> issued by the FSA to spell out the detailed interpretation, all of which are binding.<sup>23</sup> Where applicable, the Japanese authorities have provided data for

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<sup>21</sup> The term “full harmonisation” would be more appropriate than “maximum harmonisation”. In any case, the draft EU law currently under discussion in the Council and the European Parliament entails a high level of harmonisation with elements of constrained flexibility (and not full harmonisation).

<sup>22</sup> The Qs and As are only available in Japanese, so the Review Team relied on Japan's interpretation on specific issues for assessment.

<sup>23</sup> The notices constitute a formal part of the Banking Law. The FSA's supervision and inspection is conducted based on the supervisory guidelines and inspection manuals. The Qs and As represent the FSA's official



16 internationally active banks, which account for more than 50% of the Japanese banking assets.

Japan has issued final Basel III regulations. This means that the review of Japan is more detailed than the reviews of the European Union and United States where the assessments are based on drafts.

The review is based on the English translation of the Japanese rules, most of which have been translated into English. In specific cases, the review team<sup>24</sup> compared the English translation of the documents with the original Japanese text to verify the translation. A final judgment of the potential discrepancies in the translation will be subject to further analysis. The Japanese authorities also have provided supplemental information requested by the team.

#### *Preliminary findings*

Overall, the preliminary analysis of Japan's Basel II/III framework suggests broad consistency with the majority of the sections of the Basel rules. The analysis, however, revealed certain differences that will be the focus of further review by the assessment team:

- (I) the Basel III capital rules are not fully implemented (additional guidance is under preparation) and deviate in specific areas, while the rules for capital buffers are planned to be published only in 2015, one year ahead of the Basel III schedule for the implementation;
- (II) most Pillar 2 rules are not in place; and
- (III) there are a number of issues in certain aspects of risk measurement, both in terms of Pillar 1 and 2, for which the review team will seek further clarification.

#### *Definition of Capital and Capital Buffers*

While the Japanese authorities have already finalised the rules concerning the definition of capital and RWA, more detailed guidance to ensure consistency with the Basel III text is not yet established. This is particularly relevant in the areas concerning the recognition of stock acquisition rights as common equity Tier 1 capital and the deduction of deferred tax assets.<sup>25</sup>

The implementation team has also identified potential deviations in the areas of the recognition criteria for additional Tier 1 instruments as well as with respect to the cut-off date for the grandfathering of state aid instruments, which need to be investigated further in order to understand the potential impact.

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interpretation of notices. Corrective action is taken and administrative sanctions are imposed in line with these guidance documents.

<sup>24</sup> The Level 2 assessment for Japan is being undertaken by a team of six experts, headed by Ms Sylvie Matherat (Banque de France). The review team members includes: Mr Shao Changyi (China Banking Regulation Commission), Mr Mark Ginsberg (OCC), Ms Alienor Margerit (Banque de France), Mr Jinshik Son (Bank of Korea), Mr Edgar Weirauch (Deutsche Bundesbank) and Mr Daniel Westin (Swedish Riksbank). The work was coordinated by Ms Jingchun Zhang and Mr Christian Schmieder, both from the BCBS Secretariat. The team's counterparties are the Japan Financial Services Agency (FSA), and the Bank of Japan (collectively, Japanese authorities).

<sup>25</sup> The Japanese authorities indicate that Qs and As to the Notice are to be issued for clarification. The review team intends that these Qs and As should also be subject to review once becoming available.

For the capital buffers (capital conservation, countercyclical), the domestic rules are not yet in place. The Japanese authorities plan to issue the rules by 2015, ie, one year ahead of the international schedule for implementation (2016).

Loss absorbency at the point of non-viability (PON) is partially implemented, such as the resolution scheme in Japan's deposit insurance law. The authorities are currently analysing how to organise the linkage between PON requirements and the domestic resolution scheme and plan to finalise the details of the framework by the end of 2012.

#### *Pillar 1 - Minimum Capital Requirement*

For securitisation, several areas of deviation have been identified, such as in terms of re-securitisation, for ABCP exposures under the Standardised Approach and specific aspects in terms of the Internal Assessment Approach (IAA) and the Supervisory Formula Approach (SFA). Other areas of credit risk will also be subject to further analysis.

In terms of counterparty credit risk and cross-product netting, the Internal Model Method (IMM) is not yet implemented. While in practice no bank has adopted the IMM, implementation into domestic regulation is still desirable.

Concerning market risk, the team has identified areas of non-compliance with respect to the treatment of smaller trading books (<100 billion JPY and no larger than 10% of the bank's total assets) and the treatment of commodity risk, where Japanese legislation only allows banks to use the simplified approach (for those banks that choose the Standardised Measurement Method, SMM). In the former case, banks with trading activities slightly below the materiality threshold would benefit from this exception. While this issue is unlikely to have systemic implications, capital adequacy could be slightly overstated. Banks' commodity risk is limited, but the ultimate judgement of materiality will be subject to additional analysis.

With regard to operational risk, some of the detailed requirements with regard to the Advanced Measurement Approach (AMA) are not specified in the notice. Japan indicates that each of the detailed requirements in the Basel Accord is validated in the process of assessment as necessary.

#### *Pillar 2 – Supervisory Review Process*

In terms of Pillar 2, most of the rules are currently not implemented in Japan. While there is a lack of implementation<sup>26</sup>, the authorities seem to be in a position to impose additional capital charges by the Banking Act. In practice, however, the FSA does not generally appear to take such an approach. Rather the FSA examines the appropriateness of banks' comprehensive risk management and, if necessary, the FSA requires banks to take remedial action to mitigate the risks instead of requiring an additional capital charge.

#### *Next steps*

The team will follow-up with the Japanese authorities to seek clarification and data with a view towards completing a preliminary final assessment of compliance and materiality in June. These findings will then be further discussed and assessed during the on-site visit scheduled for early July in order to determine a final assessment and drafting of the final report, to be shared with the authorities in the second half of July. The final report will be delivered to the Basel Committee in September.

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<sup>26</sup> Pillar 2 aspects appear partially covered by supervisory guidelines and inspection manuals.

### **Response from the Japanese authorities**

The Japanese authorities appreciate the detailed analysis done by the assessment team to date. In particular, the authorities welcome the acknowledgement of broad consistency with the majority of the sections of the Basel rules.

The FSA is in the process of developing Qs and As and supervisory guidelines which will supplement the notices, and once they are published, issues identified as lack of implementation rules in this report will be rectified.

We disagree with the report's assertion that our rules on the recognition of additional Tier 1 instruments deviate from Basel III. The cut-off date for the grandfathering of state aid instruments is set on 31 March 2013 instead of 1 January 2013 merely reflecting the fact that the Japan's fiscal year starts in April and ends in March.

With regard to the credit and securitisation parts of Pillar 1, some additional rules need to be incorporated into our domestic rules, and the FSA intends to develop necessary notices and guidelines in the coming period. However, the current rules do not result in any material overstatement of capital ratios. Most of the additional elements needed are only relevant to advanced model methods such as IMM and IAA, which no Japanese bank has adopted yet.

Regarding the market risk exception for banks with small trading book, our impact analysis shows that the impact is very limited and is at most 0.34% of total RWA. As for commodity risk, banks are allowed to choose between the IMA and simplified SMM, which are both fully compliant with the Basel text. Banks with material commodity exposures use IMA.

In terms of Pillar 2, the overall process and framework is provided in the supervisory guidelines and inspection manuals and forms the basis for on-site and off-site review by the FSA. There are, however, some specific areas where details are not well documented yet (eg those related to IMM, residual risk and implicit support). The FSA intends to develop domestic rules on those elements in the near future.

### ***United States***

As noted above, at the time of this interim assessment, the US authorities had not published the final rule to implement the improvements to the Basel II market risk framework (Basel 2.5), nor had they published the proposed regulations to implement Basel III<sup>27</sup>. These are major components of the Basel Committee's reform programme. **Therefore, the number and nature of findings set out in the final report may change substantially from those contained in this interim report if the United States makes progress in its rulemaking process prior to the finalisation of this report.**

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<sup>27</sup> On 7 June, the Federal Reserve's Board of Governors published final Basel 2.5 and draft Basel III rules. The review team has not had time to assess whether these latest developments are compliant with the Basel text for the interim report, rather these and/or any subsequent texts will form part of the final assessment.

### *Preliminary findings*

The review team<sup>28</sup> has identified a number of **overarching issues** related to the US implementation of the Basel standards:

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

The absence of the final rule on Basel 2.5 and the proposed rule on Basel III represents a potentially significant gap in US implementation and has thus far limited the assessment conducted by the review team to the US adoption of Basel II and to the proposed US rules for Basel 2.5.

#### *Scope of application*

US core banks<sup>29</sup> are required to adopt the advanced Basel II standards, while all other banks remain subject to the Basel I standards, unless they elect to be subject to Basel II standards (these are referred to as opt-in banks). The Basel Framework is explicitly directed at “internationally active” banks – though this expression has not been defined. Basel Committee member countries are not required, therefore, to apply the framework to all their banks. However, the review team intends to assess whether the US definition of core banks inadvertently results in any non-core US bank with substantial international activities not being subject to Basel II standards.

#### *US authorities’ selection of Basel II approaches*

The US agencies have implemented the advanced Basel II approaches, but not the less advanced Basel II approaches. While jurisdictions are not required to implement the less advanced Basel II approaches, the manner in which the US agencies have implemented Basel II implies that US core banks that do not comply – or cease to comply – with the requirements of the advanced approaches are subject to approaches that differ from those contemplated in the Basel II framework for banks that do not qualify for the advanced approaches. In the United States, the advanced Basel II approaches applicable to core banks are complemented by three other capital requirements, which the US authorities have asserted result in higher minimum capital requirements: (i) a permanent floor calculated under the agencies’ general risk-based capital rules (which currently implement Basel I); (ii) the non-risk-weighted US leverage ratio; and (iii) the Pillar 2 requirements, including those under the Federal Reserve Board’s “capital plan rule”.<sup>30</sup> However, a core bank that does not

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<sup>28</sup> The Level 2 assessment team of the United States is being conducted by a team of experts led by Mr Arthur Yuen (Hong Kong Monetary Authority). The full review team comprises: Mr Thierry Bayle (Banque de France), Mr Pierpaolo Grippa (Banca d’Italia), Mr Sebastijan Hrovatin (European Commission), Mr Carlos Luna (National Banking and Securities Commission of Mexico) and Mr Naruki Mori (Bank of Japan). The team is supported by Mr Maarten Hendriks of the Basel Committee Secretariat.

<sup>29</sup> The definition of core banks includes any depository institution (ie bank or savings association) meeting either of the following two criteria: (i) consolidated total assets of \$250 billion or more; or (ii) consolidated total on-balance sheet foreign exposure of \$10 billion or more; or 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 \$250 billion or more; (ii) consolidated total on-balance sheet foreign exposure of \$10 billion or more; or (iii) having a subsidiary depository institution that is a core bank or opt-in bank. Finally, any depository institution that is a subsidiary of a core or opt-in bank is also a core bank.

<sup>30</sup> Under the “capital plan rule”, based on the Comprehensive Capital Analysis and Review (CCAR) framework using stress tests, bank holding companies with consolidated assets of greater than \$50 billion must demonstrate their ability to maintain capital above existing minimum regulatory capital ratios and above a tier 1 common ratio of 5 percent under both expected and stressed conditions over a minimum nine-quarter planning horizon.

satisfy the conditions for the advanced Basel II approaches remains subject to a Basel I-based calculation of risk-weighted assets, thus not being subject to Basel II minimum capital requirements. For example, Basel I does not include a charge for operational risk. The review team intends to discuss with the US authorities the basis for their applying a Basel I-based approach for the calculation of risk-weighted assets to core banks that do not qualify for the advanced approaches rather than the options provided by the simplified, standardised and foundation approaches under Basel II.

### *Basel II parallel run*

At the time this interim report was prepared, none of the core US banks had received permission to exit the transitional parallel run, which would require a bank to base its capital requirements on the advanced Basel II approaches (supplemented by the additional requirements discussed above). The regulatory capital ratios of the core US banks continue to be based on risk-weighted assets calculated according to the general (Basel I) 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. The review team will assess the consistency of US transitional arrangements with the corresponding Basel II standards and whether this may lead to a situation in which core banks that are not allowed to leave the parallel run over an indeterminate period are effectively subject to lower capital requirements than those provided for by Basel II for banks that do not qualify for the advanced approaches.

### *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. As a first step in this context, in December 2011 the US agencies issued a notice of proposed rulemaking (NPR) that contains alternative methodologies for calculating specific risk capital requirements for debt, securitisation and equity positions under the market risk capital rules. The review team will engage with the US agencies to assess – both in qualitative and quantitative terms – whether the proposed rulemaking is at least as robust as the corresponding Basel requirements.

In addition to the overarching issues, the review team has identified a number of **specific areas of potential difference** based on its assessment of the components of Basel II rules and the proposed rules for Basel 2.5. These areas require further review and/or an assessment of their potential materiality – taking into account that their relevance may be diminished once Basel III is implemented. So far, the main areas identified include:

### *Definition of capital*

The current US capital treatment of insurance subsidiaries of bank holding companies differs from the Basel II full deconsolidation and deduction approach. This could result in a potential overstatement of capital ratios. The Basel II treatment is however superseded by Basel III, and the issue may turn out to be irrelevant if the United States alters its treatment to align with Basel III.

### *Pillar 1 – Minimum capital requirements*

The Basel criteria for credit risk mitigation – such as requirements for collateral management, operational procedures, legal certainty and risk management processes – appear absent from the current US regulations, while the scope of eligible collateral and guarantors seems to be larger than those specified by the Basel Framework. Differences have also been

identified in the definitions and/or treatment of specific asset classes (eg credit card exposures and leasing). Further, certain overarching principles, such as the IRB approaches' minimum requirements' "use test", appear not to be explicitly enshrined in regulation.

Concerning the treatment of securitisation exposures, the main area of difference relates to the removal of references to external credit ratings and the consistency with the Basel requirements. Another area relates to the treatment of securitisations containing early amortisation features which appears to deviate from the Basel treatment.

With regard to operational risk, the main area of difference relates to the possibility as permitted in the US rules of using risk mitigants other than insurance to hedge operational risk. This contrasts with the Basel Framework, which only allows insurance as a risk mitigant.

Concerning market risk, the proposed replacement of external credit ratings with new creditworthiness metrics for specific risk poses an issue of alignment with the Basel standards. It also raises the question of whether the resulting capital charges would be equally or comparably robust.

#### *Pillar 2 – Supervisory review process*

Regarding securitisations, potential significant differences have been identified for the treatment of provision of implicit support and of the recognition of protection against first loss credit enhancements and related supervisory actions.

#### *Next steps*

The first stage of the assessment – the qualitative review of the US self-assessment – has progressed according to schedule. However, due to the delay in publishing the final Basel 2.5 rule and the proposed Basel III rule, the review team's completion of the US review within the agreed timelines has become increasingly challenging. The on-site component of the review, in which the review team will meet face-to-face with the US agencies, is currently scheduled for 25 – 29 June 2012.

#### **Response from the US authorities:**

The US agencies welcome the opportunity to respond to the interim report on the US banking agencies' implementation of the Basel framework.

We wish to comment on three of the overarching issues raised in the report. First is the scope of application, where a question is raised, does the US application of Basel II standards to "core banks," as they are called in the report, cover all banks with significant international activities? The US agencies are confident that it does.

The second issue is the selection of Basel II approaches. The interim report notes that the United States has implemented the advanced approaches, but has not offered any of the less advanced approaches as options for core banks, as allowed by the Basel framework. The report goes to suggest that, in this regard, the US implementation may fall short. The possible implication is that jurisdictions that only adopt the advanced approaches ought to develop their own versions of less advanced approaches that are close to the Basel II options and apply these to non-qualifying internationally active banks. The US agencies do not see any requirement for this in the Basel framework and, indeed, we would note that using Basel I is specifically permitted.

The third issue is related and concerns the Basel II parallel run process. Here, the review team say that they want to look into whether "core" banks not allowed to leave the parallel run ... are effectively subject to lower capital requirements [than the Basel II less advanced approaches]." This is a fair question. However, as noted in the report, the US Basel I

implementation is complemented by a leverage ratio requirement and the Federal Reserve Board's capital plan rule, which covers all "core" holding companies. Unsatisfactory capital plans have severe and specific regulatory consequences. Moreover, the Board's 2012 Comprehensive Capital Analysis and Review framework required enough capital to meet the Basel III transition schedule. Taken together, these and other US requirements such as the prompt corrective action regime are both demanding and effective relative to Basel standards.

The US agencies fully support the efforts of the Basel Committee to monitor progress in implementing the Basel capital framework in different jurisdictions and look forward to working with the US Level 2 review team in the months ahead as they complete their work.

### **Level 3**

#### *Analysis of risk-weighted assets in the banking book*

In December 2011, the Basel Committee approved a work plan to evaluate sources of material differences in risk-weighted assets (RWAs) across banks using the Internal Ratings-Based (IRB) approach for credit risk in the banking book, and assess the extent to which RWA calculations are consistent with relevant Basel standards. The work, conducted by representatives of 30 regulatory agencies from 23 countries, relies on a combination of top-down analysis of data as reported by banks, bottom-up portfolio benchmarking, observation of the range of practices across banks and supervisors, and on-site work at banks as appropriate.

The work distinguishes between variations in RWAs that are risk-based (those due to differences in underlying risk at the exposure/portfolio level) and those that are practice-based (eg those due to model selection or calibration of model parameters, exercise of judgement, application of national discretion, etc). Practice-based variations can be further subdivided into differences that are specifically provided for under the Basel Framework (eg IRB rollout, national discretions), and others that arise more from differences in interpretation of standards in the framework or from specific practices such as those related to calibration of risk parameters. Recommendations to narrow the variation in RWAs are appropriate primarily for practice-based RWA variation.<sup>31</sup>

To date, work has considered and assessed a wide range of existing analyses of RWAs across banks and countries. Most studies acknowledge that underlying differences in risk are likely to be a key driver in variations in RWA; these include differences in risk arising from differences in business model and portfolio mix. However, most studies also conclude that at least some of the variation in RWAs could be attributable to practice-based factors. For example, several studies from the regulatory community raise model calibration (particularly PD and LGD estimation) and the stage of IRB adoption as potential drivers of RWA variation. On the other hand, external analysts have focused more on differences in the application of supervisory principles, with regulatory and accounting approaches being frequently cited as reasons for differences in RWA measurement.

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<sup>31</sup> For practiced-based variations specifically provided for under the Basel framework, any proposal to reduce differences in practice will need to pay proper regard to the reasons that the Basel framework specifically permits at least some of these differences.

Existing studies reveal that, while there are many potential candidates, there is no definitive consensus on the true sources of RWA differences across banks, or on the extent to which differences are due to differences in risks or differences in practices. Thus, additional work is clearly necessary, and is being pursued.

To extend existing analyses and determine an appropriate focus for regulatory efforts to enhance convergence, the group is undertaking additional high-level analyses of RWA variation using supervisory data from the Basel Committee's Capital Monitoring Group (CMG).

- The CMG has collected information on Basel II RWA, capital requirements, and risk parameters semi-annually since end-June 2008. The data are extracted from national reporting frameworks of member countries, and submitted to the Basel Committee Secretariat in standardised reporting templates.<sup>32</sup>
- The analytical framework that will be applied to the CMG data combines existing methods with additional approaches being developed as part of this project.
- The sources and materiality of RWA differences will be assessed across portfolios, across banks, and across countries, with a focus on particular drivers believed to play a material role in RWA dispersion.
- To safeguard data confidentiality, results will be presented in anonymised or aggregated form.

Conclusions based on top-down analysis of aggregated data as described above are necessarily limited. Thus, that analysis is being supplemented with bottom-up analysis using test portfolios, in which the risk parameters banks assign to groups of common exposures are compared and analysed. The portfolio exercise is currently in development.

- Informed by a comprehensive stock-take of similar exercises conducted by the industry and by various regulatory authorities, the initial focus has been narrowed to wholesale credit. Similar analysis can be extended to other types of credit at a later stage based on the lessons and conclusions of the initial exercise.
- A data collection template has been developed, together with instructions for completion of the template.
- A list of exposures is being developed to be provided to participating banks; banks will be asked to respond with PD and LGD estimates for each exposure.
- The composition of the hypothetical portfolio has not been finalised, but is being designed to ensure maximum overlap across participating banks, and includes large sovereign borrowers, large financial institutions, and large non-financial corporate borrowers.
- Output from this work will include various benchmark analyses, including pair-wise rank-ordering analysis, analysis of the distribution of PD and LGD estimates across banks, and assessment of how the impact of the observed parameter estimates on RWAs depends on different risk profiles or business strategies.

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<sup>32</sup> The CMG dataset currently covers 56 large, internationally active banking organisations and 49 non-internationally active banking organisations in 15 countries. Countries (with number of banks) included are Australia (4), Belgium (5), Canada (6), France (6), Germany (24), Italy (4), Japan (12), Luxembourg (1), the Netherlands (6), South Africa (4), Spain (8), Sweden (8), Switzerland (2), the United Kingdom (10), and the United States (5).



Quantitative analysis using either aggregated data or hypothetical portfolio results can highlight sources of RWA variation, but will not necessarily pinpoint the reasons for that variation. Therefore, work is also under way to identify the specific practices that might underlie differences in RWAs.

- In a first phase, an extensive list of potential drivers of RWA differences has been developed, drawing on existing supervisory knowledge and judgement and informed by analysis of existing studies. The list of drivers has been divided into those related to underlying risk or risk profile, and those related to practices.
- The potential significance of the drivers has been assessed based on both magnitude and prevalence; the assessments of significance currently are being refined.
- Further analyses will be conducted to assess the materiality and the nature of a selected number of drivers.

The work described here – combining top-down data analysis, bottom-up portfolio benchmarking, and supervisory evaluation of the range of practice in specific areas<sup>33</sup> – will extend the preliminary conclusions from prior analyses by identifying selected industry and supervisory practices that appear likely to be causing differences in RWA and capital across institutions and countries that are not reflective of underlying risk. Specific recommendations for narrowing of the range of practice will be provided to the Basel Committee for consideration and possible action as appropriate. The analytical framework developed for analysing RWA differences can also serve as an approach for ongoing monitoring of RWA differences.

### ***Analysis of risk-weighted assets in the trading book***

This interim report contains the initial findings of the potential drivers of differences in market risk-related risk-weighted assets (mRWA) using data that is publicly disclosed by banks in financial and regulatory reports. The scope of these initial findings is therefore limited, since the analysis applies to public data prior to the implementation of Basel 2.5 and is based only on those banks for which sufficient data was available to make meaningful comparisons.

The Committee's task force is currently working on completing the public data analysis by, among others, evaluating the utility of non-public supervisory data. In addition, it is performing a test portfolio exercise in which the mRWA calculations of banks are compared on a common set of positions, with the results to be further investigated by means of on-site visits. A number of banks have volunteered to be included in the test portfolio exercise, which is well under way and the first results are expected in the second half of this year. The task force will include the findings of this complementary work in a final report that is expected by the end of this year.

Based on public disclosures by a sample of 17 large banks with significant trading activities, the analysis reveals considerable differences in mRWA as a ratio to total trading assets reported in financial disclosures (see Figure 1). Such variation can be justified when it reflects the varying risk profile of trading activities, given the differences in trading strategies and business models among the banks. In this regard, a preliminary analysis of the public disclosures on a subset of banks in the sample suggests that those banks that trade risky

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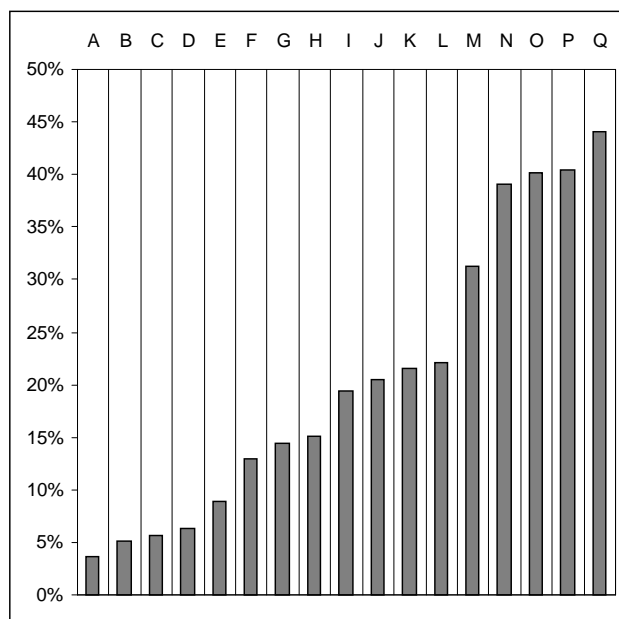
<sup>33</sup> In addition, the potential contribution of on-site visits to regulated institutions to evaluate aspects of RWA differences will be considered.

assets, such as distressed loans or less liquid equities, exhibit a higher ratio of mRWA to total trading asset.

However, the results are not conclusive, as there remains substantial unexplained variation, and in many instances public disclosures are insufficient to explain the observed variation in mRWA ratios across banks. One potential policy response is therefore to investigate further improvements in public disclosures for market risk, for instance, by including more information about mRWA and its components and providing more direction to banks regarding Pillar 3 disclosure. These policy options will be investigated further.

**Figure 1: Market Risk Weighted Assets (mRWA) at 17 Large Banks**

**Ratio of market risk weighted assets to total trading assets**



Notes: This graphic presents banks in increasing order of average market risk weighted assets (mRWA) calculated as the ratio of mRWA to Trading Assets, showing the substantial variation, from below 5% to about 45%. Trading Assets is defined as the value of all instruments in the trading account, including securities, traded loans, and net derivatives with a positive replacement value. To put banks on a comparable basis the measurement of total trading assets has been adjusted for the effect of different accounting regimes. In particular, the data has been adjusted to take into account the different approaches to netting of derivatives.

Source: public information based on banks' financial and public regulatory reporting. For bank A data is based on Q4 2010 for all other banks data is from Q2 2011.

The preliminary analysis shows a number of potential reasons for variation in mRWA (the list does not reflect a ranking in order of importance as the analysis does not allow for that at this stage):

- Differences due to variation in the composition of trading assets as evident to some extent in public disclosures.
- Differences in the way that banks apply accounting requirements to their business model in allocating assets between the trading and banking books, for example, the treatment of securities financing transactions and loans.

- Differences in methodology and inputs for market risk models used for regulatory capital calculations.<sup>34</sup>
- Differences in supervisory approaches, with some jurisdictions relying more heavily on the internal models approach and integrated VaR models while others continue to use the standardised approach selectively for some debt and equity positions.
- Differences in regulatory add-ons and notably the use of VaR multipliers higher than the minimum of 3 to account for model uncertainty.

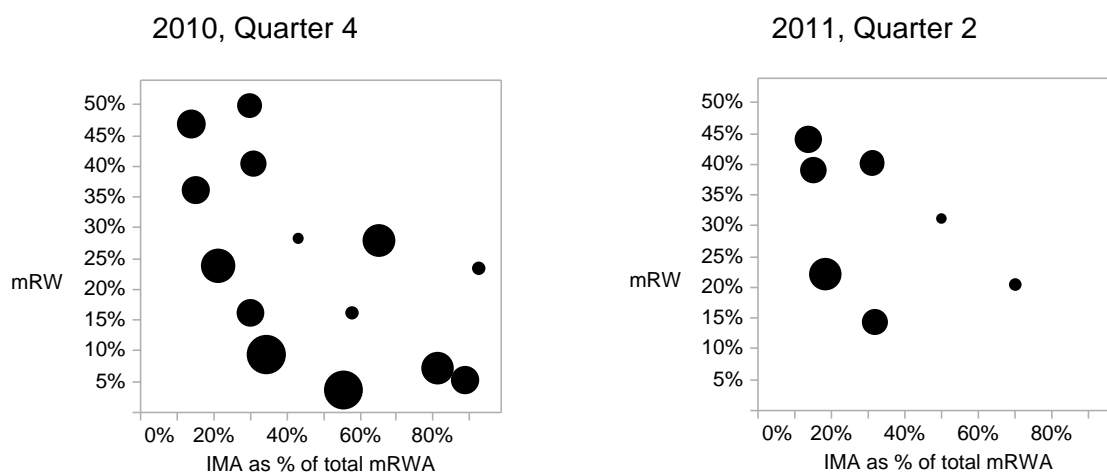
With regard to the last two points, the analysis indicates that some of the variation in mRWA as a percentage of total trading assets may be related to the degree of reliance on internal models based on Value-at-Risk (VaR). Banks for which internal models have a more important role in determining mRWA tend to show a lower average ratio of mRWA to total trading assets compared to banks for which models have a lesser role, with standardised approaches more important (see Figure 2). This is in line with expectations as the standardised approach provides for less hedging and diversification benefits and is therefore generally more conservative than the internal models approach. At the same time, however, there remains substantial unexplained variation, as there is a wide range of mRWA ratios for banks with similar reliance on models and also banks with similar mRWA ratios but varying degrees of reliance on internal models. This variation will be examined further by means of the test portfolio exercise that is currently under way.

It should be noted that the relationship between the degree of reliance on internal models and the ratio of mRWA as percentage of total RWA may change in the future. Basel 2.5 implementation (from end-2011) is expected to raise the capital charge for banks using internal models approaches for market risk and the fundamental review of the trading book aims to strengthen the relationship between the models-based and standardised approaches by establishing a closer link between the calibration of the two approaches. This may reduce the importance of the degree of reliance on internal models as an explanatory factor behind the observed differences among banks.

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<sup>34</sup> For example, a bank using a 2 year history for its historical simulation would demonstrate a decline in VaR as a result of volatile periods from 2008 dropping out of the scenarios in 2011. The choice of the length of the data window is among other factors determined by the bank's preference for how quickly changes in markets' volatility are reflected in VaR.

**Figure 2: The relationship between a bank's average market risk weight (mRWA), defined as market risk weighted assets to trading assets, and the reported use of VaR**



Notes: The horizontal axis shows mRWA from internal models approach (IMA) as percentage of total mRWA. The vertical axis shows total mRWA as a percentage of total trading assets. The sizes of the circles in the figure indicate the size of trading assets (in USD) for each bank. It should be noted that the ratio of IMA as percentage of total mRWA is an imperfect proxy for degree of reliance on internal models as for some banks a low ratio may still imply a high degree of reliance on internal models, for instance, when the internal model produces a very low mRWA compared to total mRWA.

Source: public information based on banks' financial and public regulatory reporting. Of the 17 banks in the sample, sufficient disclosure was only available for 14 banks in quarter 4, 2010 and for only 7 banks in quarter 2, 2011.

The task force has a work programme in place to further analyse the drivers of difference in mRWA across global banks. This includes:

- Completing the analysis of public data to test, refine, and extend these initial findings;
- Evaluating the utility of internal supervisory data to better understand the drivers of observed differences;
- Identifying key drivers of IRC (Incremental Risk Charge), VaR and stressed VaR based on existing domestic supervisory knowledge of bank's models (and at a later stage CRM, Comprehensive Risk Measure). The objectives of this work are to identify the key aspects of model methodology that drive the differences in internal models based approaches and to assess the materiality of these drivers at a high-level. This work will support the test portfolio exercise and help to focus attention to those areas of the internal models that most likely contribute to differences;
- Performing a test portfolio exercise to compare and assess the mRWA calculations by a sample of large, internationally-active banks for a set of hypothetical trading portfolios. The aim of the exercise is to measure potential mRWA variability due to the implementation of VaR, stressed VaR and IRC models. In addition, banks are being requested to complete questionnaires to specify the workings of their internal models;
- Carrying out selected on-site visits to some participating banks to allow for a deeper investigation of the sources of variability in the calculated mRWA. It should be stressed that the on-site visits will not be model-validation exercises, but are meant to provide further information about the workings of the banks' internal models and the resulting mRWA numbers from the test portfolio exercise. This exercise will help

to identify the major sources of mRWA variability due to modelling choices in large banks. However, as it is a hypothetical portfolio exercise it will not be able to explain mRWA variability due to the differing business strategies of large trading banks.

## **Further work**

The Basel Committee will continue to work to attain the full, timely and consistent implementation among its members. The Committee will update G20 in November on its work on all of the three levels.

### **Level 1**

The Level 1 reports will continue to be published until all Basel Committee members have fully implemented the requirements. The next publication of the tables in appendix 1 will reflect the position as at end September 2012.

### **Level 2**

Final reports for the three Level 2 assessments of the European Union, Japan and the United States are expected to be published in September. Some follow-up work may be required after September depending on the findings of the reviews. Additional work will also include the new liquidity requirements, the leverage ratio, and the surcharges for systemically important banks, once the Committee concludes its review on any revision or final adjustments for these elements of the framework. In line with the three current reviews, the review of liquidity requirements, the leverage ratio and systemic surcharges will take place ahead of the deadline and assess draft regulations where appropriate according to the staggered implementation dates.

A review of Singapore will commence later in 2012, and reviews of China and Switzerland in 2013. This schedule will mean that all countries which are home of G-SIBs will have been reviewed before the middle of 2013. Reviews of Australia and Brazil will take place during the second half of 2013. The Basel Committee is collaborating with the IMF and World Bank to ensure that its schedule is complementary and non-duplicative to the IMF and World Bank's FSAP review process.

### **Level 3**

The two Level 3 groups assessing the consistency of risk-weighted assets in the banking book and trading book will continue their detailed analyses, including hypothetical portfolio exercises, questionnaires horizontally reviewing practices across banks and jurisdictions and on-site visits to banks. Preliminary conclusions from the detailed analyses should be available in the fourth quarter of 2012.

# Appendix 1

## Level 1 charts

### Status of Basel II adoption (as of end May 2012)

Country	Basel II	Next steps – Implementation plans
Argentina	1, 4	(1) On-going work to assess the migration from Basel I to the Basel II standardised approach for credit risk. (4) Final rules for operational risk published and came into force on 30 April 2012
Australia	4	
Belgium	4	
Brazil	4	
Canada	4	
China	4	Supervisory guidelines released between 2007 and 2010 which will be integrated into new capital regulation combining Basel II, Basel 2.5 and Basel III. Large banks submitted application for advanced approaches currently assessed by CBRC.
France	4	
Germany	4	
Hong Kong SAR	4	
India	4	
Indonesia	3, 4	(3) Pillar 2 and Pillar 3 to be implemented from December 2012. (4) Pillar 1 (all elements based on standardised approaches) implemented.
Italy	4	
Japan	4	
Korea	4	
Luxembourg	4	
Mexico	4	
The Netherlands	4	
Russia	1, 4	(1) Pillar 2 expected to be implemented not earlier than 2014. Pillar 3 expected to be implemented not earlier than 2013. (4) Simplified standardised approach for credit risk, simplified approach for market risk and the Basic Indicator Approach for operational risk implemented.
Saudi Arabia	4	
Singapore	4	
South Africa	4	

Spain	4	
Sweden	4	
Switzerland	4	
Turkey	4	Parallel run on-going. Final application from July 2012.
United Kingdom	4	
United States	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 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.
European Union	4	

**Number and colour code:** 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.

### Status of Basel 2.5 adoption (as of end May 2012)

Country	Basel 2.5	Next steps – Implementation plans
Argentina	1	On-going work to draft preliminary documents.
Australia	4	
Belgium	4	
Brazil	4	
Canada	4	
China	4	Basel 2.5 included in Basel II related guidelines and to be integrated into new capital regulation.
France	4	
Germany	4	
Hong Kong SAR	4	
India	4	
Indonesia	1	Securitisation exposures in Indonesia are currently insignificant and prospects remain highly subdued for any material issuance. At the moment, no bank has adopted an internal model-based approach for market risk under Basel II rules. Indonesia will consider implementing Basel 2.5 under a phased approach when domestic conditions permit. At this stage, Indonesia is currently reviewing elements of Basel 2.5.
Italy	4	
Japan	4	
Korea	4	
Luxembourg	4	
Mexico	1	Pillar 1 requirements will be implemented by the second half of 2012.  Pillar 2 provisions are partially implemented. The remaining aspects will be implemented during 2012 and 2013, as well as the requirements under Pillar 3
The Netherlands	4	
Russia	1, 2	(1) Pillar 2 expected to be implemented not earlier than 2014.  (2) Final regulation (revision to the simplified approach for market risk) expected shortly - regulation expected to be adopted in the second half of 2012.
Saudi Arabia	3	
Singapore	4	
South Africa	4	
Spain	4	
Sweden	4, 1	(4) Final rules for the Basel 2.5 agreement are in force, including liquidity management and remuneration.  (1) The supplementary Pillar 2 guidance is, for the most part, applied in practice in the Pillar 2 supervision, however a new national ICAAP guideline is still under development.



Switzerland	4	
Turkey	1, 4	(1) On-going work to harmonise current regulation with Basel 2.5 rules - final regulation expected to be published in mid 2012.  (4) Changes related to securitisation/resecuritisation positions taken into account in the Basel III context.
United Kingdom	4	
United States	1, 2	(2) 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 by the Federal Reserve's Board of Governors on 7 June and expected to be finalised by the FDIC and OCC also in June 2012.  (1) Other Basel 2.5 revisions are under development as part of the proposed Basel III rule currently expected to be issued for comment during Q2 2012.
European Union	4	Final date for full transposition by member states of the European directive implementing Basel 2.5: 31 December 2011.

**Number and colour code:** 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.

### Status of Basel III adoption (as of end May 2012)

Country	Basel III	Next steps – Implementation plans
Argentina	1	On-going work to draft preliminary documents.
Australia	2	Draft rules for capital requirements issued on 30 March 2012. Draft rules to implement liquidity requirements issued in November 2011 for public consultation until 17 February 2012.
Belgium	(2)	(Follow EU process – Council and ECON reports published)
Brazil	2	Draft regulation published for public consultation on 17 February 2012.
Canada	2	On 1 February 2011, banks were directed to meet the 7% CET1 standard as of January 2013. Regulations for (i) non-viability contingent capital and (ii) transitioning for non-qualifying instruments published August and October 2011 respectively. Draft regulation for definition of capital and counterparty credit risk issued to banks in March 2012.
China	2	Draft regulation combines BII, B2.5 and BIII. Public consultation ended in 2011. Final rule expected to come into force in Q3 2012. Will be applied to all banking institutions.
France	(2)	(Follow EU process – Council and ECON reports published)
Germany	(2)	(Follow EU process – Council and ECON reports published)
Hong Kong SAR	1	Bill passed by the Legislative Council on 29 February 2012 and published for the purpose of creating rule-making powers for the implementation of Basel III. (3 grading in last report as at 31 March related to these new powers) Hong Kong remains on course to publish draft rules in the third quarter of 2012. Industry consultation underway on policy proposals for inclusion in rules.
India	3	Final regulations issued on 2 May 2012 which come into force from 1 January 2013.
Indonesia	1	Draft regulation to be released for consultation with industry in Q2 2012. The draft consultative paper has been discussed with representatives of the banking industry (working groups) to gather initial input.
Italy	(2)	(Follow EU process – Council and ECON reports published)
Japan	3	Final rules published on 30 March 2012 – Implementation of final rules (end of March 2013 – In Japan, the fiscal year for banks starts in April and ends in March).
Korea	1	Draft regulation to be published in the first half of 2012.
Luxembourg	(2)	(Follow EU process – Council and ECON reports published)
Mexico	2	Draft rules published on 31 May 2012.
The Netherlands	(2)	(Follow EU process – Council and ECON reports published)
Russia	1	Draft regulations to be published in the second half of 2012.
Saudi Arabia	3	Final regulation issued to banks.

Singapore	2	Public consultation on draft ended in February 2012. Final rule is expected to be published in mid 2012.
South Africa	2	Draft amendments to legislation issued on 30 March 2012 for consultation.
Spain	(2)	(Follow EU process – Council and ECON reports published)
Sweden	(2)	(Follow EU process – Council and ECON reports published)
Switzerland	2	Public consultation on draft regulation on Basel III has been finished in January 2012. Decision on final rules text expected until mid 2012. Final SIFI regulation (level: Banking Act) adopted by Parliament on 30 September 2011 – Draft SIFI regulation (level: accompanying ordinances) was published in December 2011; decision on final rule text expected before end 2012.
Turkey	1	Draft regulation expected to be published in mid-2012.
United Kingdom	(2)	(Follow EU process – Council and ECON reports published)
United States	1	Draft regulation for consultation approved at Federal Reserve's Board of Governors meeting on 7 June, and will be considered also by the FDIC and OCC in June and, pending final approval, issued thereafter. 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.
European Union	2	Council general approach published by the Danish Presidency on 21 May 2012; ECON report published on 14 May 2012.

**Number code:** 1 = draft regulation not published; 2 = draft regulation published; 3 = final rule published; 4 = final rule in force.

## Appendix 2

### Level 2 process

#### 1. Assessment framework

##### Background and objectives

Full, timely and consistent implementation of Basel III is fundamental to raising the resilience of the global banking system, in maintaining market confidence in regulatory ratios, and in providing a level playing field.

Reflecting the importance of implementation, the Committee has agreed to establish a programme to assess its members' implementation of Basel III. The implementation assessment programme is comprised of three levels of review:

- Level 1: ensuring the timely adoption of Basel III;
- Level 2: ensuring regulatory consistency with Basel III; and
- Level 3: ensuring consistency of risk-weighted asset outcomes.

This document describes the Level 2 review process, which 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.<sup>35</sup>

The Basel Committee's implementation assessment programme and the Financial Sector Assessment Program (FSAP), which is conducted by the International Monetary Fund and the World Bank (and which assesses country compliance with the Basel Committee's Core Principles for Effective Banking Supervision), have different scopes and focuses and will complement each other. In particular, the Basel III Level 2 assessment programme described in this document provides a narrower but deeper focus on the regulatory consistency with Basel III, while the assessment of the Core Principles considers the full range of the regulatory framework and supervisory practices.

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<sup>35</sup> [http://www.financialstabilityboard.org/publications/r\\_111017.pdf](http://www.financialstabilityboard.org/publications/r_111017.pdf).

## Scope of the assessments

Basel III builds upon and enhances the regulatory framework provided by 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 will thus cover the full set of components, including those introduced by Basel II and 2.5 (see the annex for the detailed scope). This full set of requirements is referred to as 'Basel III' in this document.

Basel III's liquidity ratios and the leverage ratio along with the additional loss absorbency requirement for global systemically important banks (G-SIBs) will be included in the assessments after the Committee concludes its review on any revisions or final adjustments, consistent with the agreed phase-in arrangements.

Certain jurisdictions, given their economic and development situation, that choose not to adopt some or all of the advanced approaches of Basel III for the measurement of risks will not be considered non-compliant when their compliance with the relevant provisions of Basel III is assessed; these provisions will be considered as non-applicable, in line with the approach adopted by the Committee when developing Basel II.<sup>36</sup>

## Schedule of the assessments

All Basel Committee member countries will be assessed following the process presented in this document, with the first reviews commencing in 2012. Given the resources available and the intensity of the assessments planned, the Committee will not be able to review all countries at the same time and will do a limited number of reviews per year, with initial priority given to countries with G-SIBs. Nevertheless, it is intended that all jurisdictions will be covered over a multi-year timetable.

Given the limited discretion available for EU member countries, the focus of the review for the EU and its member countries will be the EU level regulations. A report on the European Union will be supplemented with a summary of the discretions exercised at the country level by each EU member country, but country specific reports will not be prepared.

Particularly in the early phases of the assessment programme, some assessments (or parts of them) might be based on draft or proposed domestic regulations. The part of any assessments based on non-final and non-binding documents will only be regarded as preliminary assessments and will be supplemented at a later stage by a follow-up assessment of the final domestic regulation. Preliminary assessments based on draft or proposed domestic regulations will be clearly distinguished from the assessments based on the final and complete regulations.

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<sup>36</sup> Paragraph 7 of the Basel II document and its Simplified Standardised Approach in Annex 11 show the Committee's intention to provide a range of options to allow supervisors to select approaches that are most appropriate for their financial market infrastructure.

## 2. Assessment methodology

### General approach

The objective of the assessment is to ensure that domestic regulations implementing Basel III comply with the agreed international minimum requirements. Although this document refers to “regulations”, the term is used solely for simplicity: the Committee is aware that Basel III can be implemented by different means depending on the legal and regulatory framework within a given jurisdiction. For the purpose of assessing compliance, the Committee will consider all binding documents that effectively implement Basel III.

The Level 2 assessment will focus on reviewing the **content** of domestic regulations (the extent to which Basel III is effectively enforced by supervisors or whether firms are actually complying with the rules of the Basel III framework will be assessed as part of the Level 3 assessment process). The assessment of compliance with the international rules will primarily be factual and will be based on two aspects:

- a comparison of domestic regulations with the international agreements to identify if all the required provisions of Basel III have been adopted (completeness of the regulation); and
- independent of the form of the requirements, whether there are any differences in substance between the domestic regulation and the international agreement (consistency of the regulation).

When a gap or a difference is identified, a key driver for assessing compliance will be its materiality and impact. To the extent possible, the materiality and impact will be quantified using all available data, including those submitted by the jurisdiction being assessed. The assessment will, in particular, seek to measure the significance of any identified difference(s) for internationally active banks or certain types of firms or businesses. The assessment will consider the current impact and consequences, but also its potential impact in the future.

The assessment will also seek to clarify the rationale for any identified gaps and differences between the domestic provisions and the corresponding international rules, with a view to ensuring a firm understanding of the specificities and drivers of local implementation. However, these elements will not be taken into account when assessing compliance: local specificities will not be seen as mitigants for going beyond the scope of national discretion specified within Basel III.

Domestic measures that strengthen the minimum requirements are fully in line with the nature of the international agreements, which are intended to set minimum requirements, and will therefore be considered as compliant. However, they will not be considered to compensate for inconsistencies or gaps identified elsewhere, unless they fully and directly address the identified inconsistencies or gaps.

### Compliance scale

All assessments will be summarised using a four-grade scale: compliant, largely compliant, materially non-compliant and non-compliant.<sup>37</sup>

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<sup>37</sup> 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, and as noted

- Regulatory framework is *compliant* with Basel III: A regulation will be considered compliant with Basel III if all minimum provisions of the international framework have been satisfied and if no material differences have been identified which would give rise to prudential concerns or provide a competitive advantage to internationally active banks.
- Regulatory framework is *largely compliant* with Basel III: A regulation will be considered largely compliant with Basel III if only minor provisions of the international framework have not been satisfied and if only differences that have a limited impact on financial stability or the international level playing field have been identified.
- Regulatory framework is *materially non-compliant* with Basel III: A regulation will be considered materially non-compliant with Basel III if key provisions of Basel III have not been satisfied or if differences that could materially impact financial stability or the international level playing field have been identified.
- Regulation is *non-compliant* with Basel III. A regulation will be considered non-compliant with Basel III if Basel III has not been adopted or if differences that could severely impact financial stability or the international level playing field have been identified.

The outcome of the assessment process is expected to take the form of an overall assessment of the compliance of the jurisdiction's regulation with Basel III and assessments of the compliance of the jurisdiction's regulation for each of the key components of the capital framework as listed in the annex.

### **3. Assessment process**

Each assessment will be based on peer review, and have three main steps: a preparatory phase, the assessment phase itself, and the review phase that will result in the approval of the conclusions of the assessment. A follow-up phase will also occur at a later point in time.

#### **Phase 1: Preparatory phase**

The preparatory phase will be used to establish the assessment team and to collect the relevant material.

##### **(a) Establishment of assessment teams**

Ad-hoc assessment teams will be established to conduct the assessment of individual jurisdictions. A typical team will involve 5-7 persons, comprising:

- a team leader with seniority and/or experience equivalent to those of a Committee member

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above, components of Basel III that are not relevant to an individual jurisdiction may be assessed as non-applicable.

- selected experts from member authorities; and
- member(s) of the Basel Committee Secretariat.

**(b) Collection of Information and data**

The preparatory phase will be used to collect the information needed for supporting the assessment. Jurisdictions will be requested to answer a detailed self-assessment questionnaire, using a standardised template, and to provide all components of the domestic regulation that implement Basel III at the domestic level. Relevant background documents should also be communicated, including in particular copies of the most recent FSAPs or other external assessments which cover capital adequacy regulation. The jurisdiction should also transmit any other document that could usefully inform the assessment.

**Phase 2: Assessment phase**

The assessment phase will rely on a combination of off-site and on-site assessments.

**(a) Off-site assessment**

The assessment team will analyse the compliance of the domestic regulations using all the information provided by the country, as well as other relevant information available to the Basel Committee. The assessment team may choose to consult the authorities within the jurisdiction being assessed during this period to seek additional information or clarification, or might consult relevant expert groups of the Basel Committee for an indicative view on certain technical issues. This phase should primarily seek to identify the issues that will need to be explored and discussed in more detail during the on-site review.

**(b) On-site assessment**

As a general principle, on-site reviews are expected to be conducted as part of the assessment process. On-site reviews will provide the best opportunity to ensure the correct understanding of issues related to the adoption and implementation of Basel III identified during the off-site review, by having exchanges with relevant experts and the senior authorities responsible for the transposition of Basel III into domestic regulations. The length and content of each on-site review will be set based on the complexity of the domestic implementation and on the materiality of the issue identified.

Domestic banking regulators and supervisors are expected to be the key counterparts of the assessment team during the on-site reviews, but meetings with other relevant parties (including the finance ministry or treasury, industry representatives, accounting representatives, analysts) may also take place to ensure that the assessment team collects a broad range of views and develops a sound understanding of local regulatory requirements. If scheduled, meetings with the private sector are expected to take place without the participation of representatives of the domestic authorities.

**(c) Drafting of the assessment report**

The information collected during the off-site and the on-site assessments will be used to prepare an assessment report. Jurisdictions being assessed will be given an opportunity to comment on the draft report before it is presented for the review phase.



### **Phase 3: Review phase**

The review phase corresponds to the review of the assessment by a broader set of peers, the finalisation and approval of the report, and its subsequent publication.

#### **(a) Review by the Standards Implementation Group**

The substantive review by a broader set of peers will take place in the Standards Implementation Group (SIG) of the Basel Committee. The key objectives of the SIG's review of the assessment report are to (i) agree on the conclusions of the assessment and on the content of the report and (ii) to ensure that the assessment is consistent with the agreed methodology and the other assessments already performed. As part of this process, the jurisdiction being assessed will have the opportunity to present its views on the findings of the assessment report to the SIG.

#### **(b) Approval by the Basel Committee**

The Basel Committee has the final responsibility for approving the assessment report. The assessments will be approved by consensus. The representatives of the country assessed will not take part in the decision making but their views will be reflected in a separate section of the report if needed. If full consensus cannot be reached during the Committee meeting to which the report is presented, minority views will be footnoted in the report.

#### **(c) Publication and communication of the assessments**

After having been formally approved by the Committee, the report, including if applicable the separate views from the assessed jurisdiction, will be published on the Committee's website. The Committee member assessed will also be invited to publish the report in their home jurisdiction.

The report will also be transmitted to the FSB, consistent with its "*Coordination Framework for Monitoring the Implementation of Agreed G20/FSB Financial Reforms*".

The main conclusions of the assessments will be periodically summarised and reflected in updates of the Committee's *Progress report on Basel III implementation*, to provide a comprehensive view of the situation across member countries.

### **Phase 4: Follow-up**

The Committee will continue to monitor whether its members are updating their domestic regulations or introducing new regulations that could impact the assessments already performed. Where substantial regulatory developments or changes that could have a material impact on existing assessments take place, the Committee will take steps to update these assessments in a reasonable timeframe. The Committee may also update assessments when it concludes its review on any revisions or final adjustments of certain components of Basel III.

While the main objective of the assessment process is to ensure a full and consistent implementation of Basel III across countries, the process is also expected to usefully inform the Committee about implementation challenges or difficulties that countries may have faced or are facing when adopting Basel III. The process is also expected to contribute to identify potential gaps or interpretative issues within the Basel III framework. These elements, in combination with the outcome of its quantitative monitoring of Basel III impact, will be taken

into account by the Basel Committee when determining its policy agenda and might result in issuing additional guidance or updating the rules if needed.

# Annex

## Scope of the assessment

Key components of the Basel framework	Inclusion in the assessments
<b>Capital requirements</b>	
Scope of application	Included
Transitional arrangements	Included
Definition of capital	Included
<b>Pillar 1: Minimum capital requirements</b>	
Credit Risk: Standardised Approach	Included
Credit risk: Internal Ratings-Based approach	Included if adopted
Credit risk: securitisation framework	Included
Counterparty credit risk rules	Included
Market risk: standardised measurement method	Included
Market risk: internal models approach	Included if adopted
Operational risk: Basic Indicator Approach and Standardised Approach	Included
Operational risk: advanced measurement approaches	Included if adopted
Capital buffers (conservation and countercyclical)	Included
G-SIB additional loss absorbency requirements	Included if relevant (1)
<b>Pillar 2: Supervisory Review Process</b>	
Legal and regulatory framework for the Supervisory Review Process and for taking supervisory actions	Included
<b>Pillar 3: Market Discipline</b>	
Disclosure requirements	Included
<b>Liquidity standards</b>	
Scope of application	Included (1)
Transitional arrangements	Included (1)
Liquidity Coverage Ratio	Included (1)
Net Stable Funding Ratio	Included (1)
<b>Leverage ratio</b>	
Leverage ratio	Included (1)

(1) To be included after the Committee concludes its review on any revisions or final adjustments.