

Key Aspects of the Final Rule on Risk-Based Capital Standards: Advanced Capital Adequacy Framework – Basel II

I. Introduction

The final rule is generally consistent with the advanced approaches outlined in the Basel Committee on Banking Supervision document *International Convergence of Capital Measurement and Capital Standards: A Revised Framework, Comprehensive Version*, published in June 2006 (Basel II framework, or framework). The final rule requires certain banks (core banks), and permits other banks (opt-in banks), to use the advanced internal ratings-based approach (AIRB) to calculate regulatory credit risk capital requirements and the advanced measurement approach (AMA) to calculate regulatory operational risk capital requirements. Both core and opt-in banks will remain subject to the present agency rules for Prompt Corrective Action and the leverage ratio.

Specifically, the final rule sets forth the U.S. banking and thrift regulatory agencies' (Agencies) requirements for the U.S. implementation of the AIRB for assessing credit risk capital charges and the AMA for assessing operational risk capital charges. The use of the AIRB and AMA (collectively, the Advanced Approaches) will be required for a core group of large and internationally active U.S. banking organizations (core banks) and allowed for other banking organizations that, on an opt-in basis, are able to qualify for the framework (opt-in banks). Core banks are banking organizations with consolidated total assets (excluding assets held by an insurance underwriting subsidiary of a bank holding company) of \$250 billion or more, or with consolidated total on-balance sheet foreign exposure of \$10 billion or more. A bank must also apply the Advanced Approaches if it is a subsidiary of another bank or bank holding company that uses the Advanced Approaches, unless it is exempted by its primary federal supervisor from being required to use the Advanced Approaches.

Under the final rule, a bank's on- and off-balance sheet exposures will be divided into four categories: wholesale, retail, securitization and equity. A bank must calculate for each wholesale and retail credit exposure or pool of credit exposures certain key risk

inputs, which are described later in this document. These inputs, in conjunction with supervisory formulas described in the rule, determine the risk-based capital requirement.

The final rule also contains a regulatory capital charge for operational risk. Operational risk is the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events.

The Basel II framework allows three options for calculating capital requirements, which includes the AIRB that is adopted in the attached final rule, a Foundation Approach, and a Standardized Approach. The Agencies are currently developing a Notice of Proposed Rulemaking (NPR) that would provide banks that are not subject to the Advanced Approaches framework with the option of adopting the Standardized Approach of the Basel II framework (Basel II Standardized NPR). The Basel II Standardized NPR will replace the Basel IA notice of proposed rulemaking that was issued on December 26, 2006.¹ The Agencies will pose a question in the Basel II Standardized NPR whether core banking organizations should be allowed to adopt the Standardized Approach as an alternative.

II. Basel II Final Rule

A comprehensive description of the final rule, or all the changes made in response to comments on the Agencies' 2006 Advanced Approaches NPR, is beyond the scope of this document.² The interested reader is referred to the *Federal Register* notice. The remainder of this document provides only a few highlights of the final rule.

Pillar 1: Minimum Risk-Based Capital Requirements

U.S. banks and banking organizations are subject to a dual framework of capital regulation. A set of leverage requirements specifies the minimum amount of tier 1

¹ 71 FR 77446 (December 26, 2006).

² 71 FR 55830 (September 25, 2006).

capital that banks and banking organizations must hold as a percentage of balance sheet assets. For insured banks, the leverage requirements are an integral component of the statutory framework of Prompt Corrective Action (PCA) mandated in the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).³ The leverage and PCA requirements are unaffected by this final rule.

Risk-based capital requirements complement the leverage requirements by requiring capital for risks that are either not reflected on the balance sheet, or that pose materially more risk than the leverage requirements were designed to address. Current risk-based capital rules involve converting the notional amounts of off-balance sheet risks to on-balance sheet equivalents using defined conversion factors, and then requiring capital for the resulting on-balance sheet equivalents, and for all other balance-sheet items, using predefined risk buckets. Current rules also prescribe separate capital requirements for market risk, which apply to a small number of U.S. banks.

Other risks facing banks, such as interest rate risk on exposures held outside the trading account, liquidity risk, strategic or business risk, and reputational risk associated with off-balance sheet activities (for example, with certain asset-backed commercial paper conduits) are not explicitly addressed either by the Advanced Approaches or by the current risk-based capital requirements. These risks will be addressed under the second pillar of the Basel II framework, supervisory review (Pillar 2), which is described later in this document.

Credit Risk. The final rule requires core banks to use the AIRB approach for determining risk-based capital requirements for credit risks. The AIRB approach requires banks to estimate certain key risk parameters for each credit exposure or pool of exposures. Banks must then feed these risk parameters into predefined formulas (supervisory formulas). The supervisory formulas identify the amount of risk-weighted assets that are required for each exposure or pool of exposures. The amount of risk-weighted assets is a function of the risk parameters input by the bank into the supervisory

³ Statutory PCA requirements apply only to insured depository institutions, not their corporate owners.

formulas. The minimum capital requirement is then, by definition, eight percent of the risk-weighted asset amount (an adjustment to the capital requirement based upon the level of the institution's loan loss reserves is described later).

The AIRB framework is broadly similar to the credit value-at-risk (VaR) approaches used by some banks as the basis for their internal assessment of the economic capital necessary to cover credit risk. It is common for a bank's internal credit risk models to consider a one-year loss horizon, and to focus on a high loss threshold confidence level. As with the internal credit VaR models used by banks, the output of the risk-based capital formulas in the AIRB framework is an estimate of the amount of credit losses over a one-year horizon that would only be exceeded a small percentage of the time. The Agencies' use of a one-year loss horizon is intended to balance the fact that banking book positions likely could not be easily or rapidly exited, with the possibility that a bank could attempt to cover credit losses by raising additional capital should the underlying credit problems manifest themselves gradually. The nominal confidence level of the AIRB risk-based capital formulas (99.9 percent) means that if all the assumptions in the AIRB supervisory model for credit risk were correct for a bank, there would be less than a 0.1 percent probability that credit losses at the bank in any year would exceed the AIRB risk-based capital requirement.⁴

Exposure at default (EAD). To calculate capital requirements for credit risk using the supervisory formulas, banks must estimate certain key risk inputs for each credit exposure or pool of exposures. The first key risk parameter banks must estimate is the exposure at default, or EAD. This is a dollar amount, and it is important because it is the amount against which capital will be held. The EAD of a credit exposure must at least equal the amount of the exposure that is carried on the balance sheet. For portions of an exposure that reside off balance sheet, the EAD is the bank's own estimate of the amount of the exposure that would likely be owed the bank if there were a default. This

⁴ Banks' internal economic capital models typically focus on measures of equity capital, whereas the total regulatory capital measure underlying this proposal includes not only equity capital, but also certain debt and hybrid instruments, such as subordinated debt. Thus, the 99.9 percent nominal confidence level embodied in the IRB framework is not directly comparable to the nominal solvency standards underpinning banks' economic capital models.

contrasts with current rules: Instead of converting off-balance sheet amounts using predefined regulatory conversion factors, these amounts are converted based on each bank's own estimate of the appropriate conversion factor.

Probability of default (PD). The second key risk parameter determining the capital requirement for a credit exposure is the probability of default, or PD. The PD is the bank's estimate of the probability the borrower will default over the next 12 months. It is intended to be a conservatively estimated "through the cycle" average of default rates the credit exposure would be likely to experience during both expansionary and recessionary periods of economic activity. The rule gives banks significant flexibility as to how they will estimate their PDs, but these estimates are expected to be supported by historical data including default data from recession periods.

Capital requirements under the rule will depend importantly on banks' PDs. These PDs, in turn, will depend on the way defaults are defined in the banks' databases. Thus, the definition of default is of fundamental importance to the operation of the rule. In the final rule, the Agencies have changed the definition of default for wholesale credit exposures from that proposed in the NPR.

The Agencies have adopted a definition of default for wholesale exposures in the final rule that is consistent with the Basel II framework. In particular, the final rule has deleted the NPR's requirement that default is triggered by a bank incurring a credit-related loss of 5 percent or more of the exposure's initial carrying value in connection with the sale of the exposure or the transfer of the exposure to the held-for-sale, available-for-sale, trading account, or other reporting category. Under the final rule, a bank's wholesale obligor is in default if:

- The bank determines that the obligor is unlikely to pay its credit obligations to the bank in full, without recourse by the bank to actions such as realizing collateral (if held); or
- The obligor is past due more than 90 days on any material credit obligation(s) to the bank.

In the preamble to the final rule, the Agencies provide a discussion of what may constitute an indication of an obligor's unlikelihood to pay its credit obligations in full.

For retail exposures, the final rule retains the proposed definition of default, which is consistent with the Basel II framework. However, the Agencies clarified that, subject to certain considerations, a foreign subsidiary of a U.S. bank may, in its consolidated risk-based capital calculations, use the applicable host jurisdiction definition of default for retail exposures of the foreign subsidiary in that jurisdiction.

Loss given default (LGD). The third determinant of the capital requirement is the loss given default or LGD. LGD is the bank's estimate of the credit loss as a percentage of exposure in the event the borrower defaults. LGD is especially important because the capital requirement is a straight line multiple of the LGD. For example, required capital for an exposure whose LGD is 20 percent will be exactly one half the amount that would be required if the LGD were 40 percent. Similarly, required capital would be zero if the LGD were zero. The LGD is expected to include all material credit related losses including indirect expenses and an appropriate risk-adjusted discount rate for defaulted assets held in a workout mode. It is also expected to reflect the loss experience likely to be realized during economic downturn conditions.

Maturity (M). A bank must also calculate a maturity adjustment, or M, for each wholesale exposure. For wholesale exposures, other than repo-style transactions, eligible margin loans, and certain over the counter (OTC) derivative contracts, M is the weighted-average remaining maturity of the expected contractual cash flows from the exposure, using undiscounted cash flows as weights. For repo-style transactions, eligible margin loans and certain OTC derivative contracts, M is the weighted-average remaining maturity of the individual transactions subject to a qualifying master netting agreement, with the transaction weight based on the transaction's notional amount. For most exposures, M may be no greater than five years and no less than one year; however, for certain transactions with an original maturity of less than one year, M may be set as low as one day.

Expected loss (EL). A final determinant of required capital for a credit exposure or pool of exposures is the expected loss, or EL, defined as the product of EAD, PD and LGD. For example, consider a pool of subprime credit card loans with an EAD of \$100. The PD is 10 percent – in other words, \$10 of cards per year are expected to default, on average. The LGD is 90 percent, so that the loss on the \$10 of defaults is expected to be \$9. The EL is then \$100 multiplied by 0.10 multiplied by 0.90, that is, \$9. EL can be interpreted as the amount of credit losses the lender expects to experience in the normal course of business, year in and year out. If the total EL for the bank, on all its exposures, is less than its allowance for loan and lease losses (ALLL), the excess ALLL is included in the bank's tier 2 capital (this credit is capped at 0.6 percent of credit risk-weighted assets). Conversely, if the total EL exceeds the ALLL, the excess EL is deducted from capital, half from tier 1 and half from tier 2. In this example, the EL that would be compared to the ALLL was a very substantial 9 percent of the exposure. The example is intended to illustrate that for subprime lenders or other lenders involved in high charge-off, high margin businesses, the EL capital adjustment may be significant.

Definition of Securitization Exposures and Hedge Funds. Under the final rule, a traditional securitization is a transaction in which:

- All or a portion of the credit risk of one or more underlying exposures is transferred to one or more third parties other than through the use of credit derivatives or guarantees;
- The credit risk associated with the underlying exposures has been separated into at least two tranches reflecting different levels of seniority;
- Performance of the securitization exposures depends upon the performance of the underlying exposures;
- All or substantially all of the underlying exposures are financial exposures (such as loans, commitments, credit derivatives, guarantees, receivables, asset-backed securities, mortgage-backed securities, other debt securities, or equity securities);
- The underlying exposures are not owned by an operating company;

- The underlying exposures are not owned by a small business investment company; and
- The underlying exposures are not owned by a firm an investment in which qualifies as a community development investment.

The final rule also provides the primary federal supervisor of a bank with discretion to exclude from the definition of a traditional securitization those investment firms that exercise substantially unfettered control over the size and composition of their assets, liabilities, and off-balance sheet transactions. The Agencies will consider a number of factors in the exercise of this discretion, including the assessment of the investment firm's leverage, risk profile, and economic substance. This supervisory exclusion is intended to provide discretion to the primary federal supervisor to distinguish structured finance transactions, to which the securitization framework was designed to apply, from more flexible investment firms such as many hedge funds and private equity funds. If the primary federal supervisor excludes an investment that has greater than immaterial leverage, the exposure will be risk weighted at 600 percent.

Securitization Exposures. Securitization exposures are instruments in which there is a tranching of credit risk. Securitization exposures may include mortgage-backed securities, collateralized debt obligations, asset-backed commercial paper, certain types of loan participations, structured investment vehicles and hedge fund exposures.

The final rule provides a hierarchy of approaches that must be used to determine the risk-based capital requirement for a securitization exposure: the ratings-based approach (RBA), the internal assessment approach (IAA), and the supervisory formula approach (SFA). Under the RBA, banks determine risk weights for securitization exposures based on the external ratings assigned to each exposure by a nationally recognized statistical rating organization (NRSRO). The final rule provides a matrix that assigns a risk weight to each external rating depending upon the exposures' seniority and the amount of granularity in the securitization's underlying asset pool. For the IAA, the bank will calculate its risk-based capital requirement for a securitization exposure to an

asset-backed commercial paper program by mapping the bank's internal credit assessment of the asset-backed commercial paper securitization exposure to an equivalent NRSRO credit rating. Under the SFA, the bank will apply a formula specified in the final rule for securitization exposures.

Equity Exposures. Equity exposures include publicly traded and non-publicly traded stock as well as instruments (other than securitization exposures) in which the return on the instrument is based on the performance of an instrument representing a direct or direct ownership interest in a company.

The final rule provides two approaches to calculate risk-based capital for equity exposures: the simple risk-weight approach (SRWA) and the internal models approach (IMA). The SRWA generally applies a 300 percent risk weight to publicly traded equity exposures and a 400 percent risk weight to non-publicly traded equity exposures. The final rule also provides for risk weights between zero percent and 100 percent for certain equity exposures, such as equity exposures to a Federal Reserve Bank, Federal Home Loan Bank, or community development corporations. In addition, the SRWA allows a portion of "non-material" equity exposures, up to 10 percent of tier 1 capital plus tier 2 capital, to receive a 100 percent risk weight.

The IMA allows a bank to develop an internal model to produce an estimate of potential loss that is not less than an estimate produced by a Value at Risk methodology using specified parameters. However, a bank generally may not assign a risk weight of less than 200 percent to publicly traded equity exposures and 300 percent to non-publicly traded equity exposures. In addition, if the bank uses the IMA, it is not eligible to assign a preferential risk weight to any "non-material" portion of its equity exposure. A bank may not apply the IMA to equity exposures that receive a zero, 20, or 100 percent risk weight under the SRWA.

Operational Risk. The final rule also provides for the use of the AMA for determining risk-based capital requirements for operational risk. Operational risk is

defined as the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events. This definition also includes legal risk – which is the risk of loss (including litigation costs, settlements, and regulatory fines) resulting from the failure of the bank to comply with laws, regulations, prudent ethical standards, and contractual obligations in any aspect of the bank’s business – but excludes strategic and reputational risks.

Under the AMA, a bank will use its internal operational risk management systems and processes to assess its exposure to operational risk. Given the complexities involved in measuring operational risk, the AMA provides banks with substantial flexibility and, therefore, does not require a bank to use specific methodologies or distribution assumptions. Nevertheless, a bank using the AMA must demonstrate to the satisfaction of its primary federal supervisor that its systems for managing and measuring operational risk meet established standards, including producing an estimate of operational risk exposure that meets a one-year, 99.9th percentile confidence interval. A bank’s estimate of operational risk exposure includes both expected operational loss (EOL) and unexpected operational loss (UOL) and forms the basis of the bank’s risk-based capital requirement for operational risk.

The AMA allows a bank to base its risk-based capital requirement for operational risk on UOL alone if the bank can demonstrate to the satisfaction of its primary federal supervisor that the bank has eligible operational risk offsets, such as certain operational risk reserves, that equal or exceed the bank’s EOL. To the extent that eligible operational risk offsets are less than the EOL, the bank’s risk-based capital requirement for operational risk must incorporate the shortfall.

Market Risk. The Agencies are finalizing the rulemaking that would change certain aspects of the Agencies’ market risk capital rules. The proposal will improve risk sensitivity and enhance the disclosure of qualitative and quantitative factors.

Total Capital Requirement. The total capital requirement for a bank subject to this final rule includes the amount of capital determined by the application of the AIRB framework and the amount determined for operational risk under the AMA formulas (and, for banks subject to the market risk capital standards, a market risk capital charge).

The formulas derive an actual dollar amount for a capital requirement. Accordingly, in order to calculate capital ratios for regulatory purposes, the Advanced Approaches transform this direct capital requirement into a risk-weighted assets equivalent. This is done by multiplying the dollar amount of the calculated capital charge by a 12.5 conversion factor – the reciprocal of the 8 percent minimum capital requirement.

Pillar 2: Supervision

The second pillar of the Basel II framework, supervisory review, outlines several principles highlighting the need for banks to assess their capital adequacy positions relative to risk, and the need for supervisors to review and take appropriate actions in response to those assessments, such as requiring additional buffer capital given the risk profile of the institution. While the final rule primarily focuses on the first pillar, minimum capital requirements, there are significant provisions within the rule that require supervisory review.

The Agencies intend that banks adopting the Advanced Approaches possess the highest level and quality of internal risk measurement and management systems. Not only must these banks develop and maintain qualifying loss and default data for portfolios subject to the AIRB framework, but those measurement systems must be subject to strict internal control processes, stress testing and validation programs, independent review and oversight, and other qualitative standards.

Similar standards are required for the measurement and management of operational risk. Clearly, a capital standard is not the sole or complete solution to address operational risks. As described in the final rule, the AMA for determining a capital charge for operational risk will depend heavily upon supervisory judgment. Active federal supervision, independent auditors, effective internal controls and strong bank management are obvious key components.

In February 2007, the Agencies issued proposed guidance for a bank's internal capital adequacy assessment process (ICAAP) and the process for a comprehensive supervisory assessment of capital adequacy.⁵ A bank's primary federal supervisor will assess the bank's overall capital adequacy and will take into account a bank's ICAAP, its compliance with the minimum capital requirements set forth in this rule, and all other relevant information. The primary federal supervisor will require a bank under its jurisdiction to increase its capital levels if the supervisor determines that current levels are deficient or some element of the bank's business practices suggests the need for more capital. In addition, a primary federal supervisor may, under its enforcement authority, require a bank to modify or enhance risk management and internal control authority, or reduce risk exposures, or take any other action as deemed necessary to address identified supervisory concerns.

Pillar 3: Disclosures

Market discipline is a key component of the Basel II framework. Under the third pillar, disclosure requirements are established to allow market participants to assess key information about an institution's risk profile and its associated level of capital, provide for comparability of risk elements, and at the same time allow bank management adequate flexibility. Increased disclosures, especially regarding a bank's use of the AIRB approach for credit risk and the AMA for operational risk, are intended to allow an institution's private sector stakeholders to more fully evaluate the institution's financial

⁵ 72 FR 9189, February 28, 2007.

condition, including its capital adequacy. This greater transparency is critical in order to foster the development of a significant amount of market discipline.

The final rule requires the top-tier legal entity at the global, consolidated level – either the top-tier banking holding company or depository institution, if not under a holding company structure – to make certain mandatory disclosures on a quarterly basis. The final rule also requires one or more senior officers of the bank to attest that the disclosures meet the Agencies' requirements.

In addition to disclosing risk-based capital ratios and their components, the reporting entity must also report other information that is designed to enable market participants to better evaluate the bank's capital structure, risk exposure, risk management performance, and capital adequacy. To further enhance transparency, the reporting entity is encouraged to place all disclosures made over the last three years in a single location on the bank's public Web site.

The final rule requires each reporting entity to have a formal disclosure policy that is approved by the board of directors. This policy must provide for effective internal controls and disclosure controls and procedures to ensure that appropriate verification of the disclosure takes place.

Separately from this final rule, the Agencies will require insured depository institutions (IDIs) and holding companies to report certain supporting details of their risk-based capital calculations on their quarterly reports of financial condition and income filed with the federal banking agencies. Finally, separately from this final rule, the Agencies will collect on a confidential basis from each IDI and holding company adopting the new framework, more detailed data supporting the capital calculations for each type of exposure. Such information will be shared among the Agencies and used for purposes of benchmarking, analyzing trends and promoting consistency in the implementation of these proposals.

A bank's material noncompliance with the qualification requirements is an important factor in market participants' assessments of a bank's risk profile. Under the final rule, a primary federal supervisor may require public disclosure of material noncompliance with the qualification requirements.

Domestic Implementation and Timeline

Both core and opt-in banks will be required to comply with all qualification standards concerning the internal ratings systems used to measure credit and operational risk exposures and will be subject to supervisory requirements for risk management before being able to apply the final rule for regulatory capital calculation purposes. Also, under the final rule, all U.S. institutions will continue to calculate the numerator of the regulatory risk-based capital ratios in a manner substantially similar to the way it is currently calculated. Except for the adjustment based on the difference between EL and ALLL described above, and a few new capital deductions required for advanced banks, the elements of capital will be unchanged under the final rule.

In addition, notwithstanding the presumptive requirement that all IDI subsidiaries adopt the Advanced Approaches if their holding company is adopting the Advanced Approaches, an IDI may request an exemption from its primary federal supervisor from the requirement to adopt the Basel II framework. The primary federal supervisor may grant such a request based on factors such as the size, complexity or risk profile of the IDI. Any such requests would be carefully considered to ensure that banking organizations are not "cherry picking" the framework by requesting exemptions for the purpose of selectively applying capital regimes across IDIs in order to minimize regulatory capital requirements.

As indicated earlier, all insured banks will continue to comply with the existing leverage ratio requirements under existing PCA legislation and implementing regulations. Specifically, to be considered well-capitalized under PCA, a bank must have at least a 10 percent total risk-based capital ratio, a 6 percent tier 1 risk-based capital ratio, and a 5

percent leverage ratio. The leverage ratio is the ratio of Tier 1 capital to average total assets. These and other PCA categories will not change.

Under the final rule, all banks will need to submit an implementation plan for approval to their primary supervisors and successfully complete a parallel run of at least four consecutive quarters before they will be allowed to apply the final rule for purposes of determining minimum regulatory capital requirements. During the parallel run, the bank will remain subject to the general risk-based capital rules, including ratios required for PCA, but will also be required to calculate its capital ratios using the advanced approaches included in the final rule.

The bank's primary federal supervisor will have responsibility for determining the bank's readiness to apply an Advanced Approach and is ultimately responsible, after consultation with other relevant supervisors, for determining whether the institution satisfies the qualifying criteria for the AIRB and AMA. The Agencies recognize that interagency consistency in implementing the Advanced Approaches will be important to the ultimate success of any final standards to be implemented and they are developing a uniform set of validation standards and procedures that will ensure consistency.

The bank's primary federal supervisor will notify the bank of the date that it may begin using the Advanced Approaches for determining risk-based capital requirements. However, the final rule imposes three transitional floor periods that limit the amount by which capital may decline under the Advanced Approaches of the final rule relative to the general risk-based capital rules. The bank's primary federal supervisor will inform the bank when it may move from one transitional floor period to the next, and, provided the Agencies release an interagency study finding no material deficiencies with the framework that cannot be addressed with then-existing tools, when it may exit the final transitional floor period.

During the initial transitional floor period for a core or opt-in bank, the bank will be required to calculate its risk-weighted assets under the general risk-based capital rules

and multiply by the appropriate transitional floor percentage provided in Table 1. The resulting “floor-adjusted” risk-weighted assets will then be used as the denominator for purposes of determining risk-based capital ratios using the general risk-based capital rules. The resulting capital ratios will be compared against the capital ratios determined under the final rule, with the lower of the ratios binding for risk-based capital and PCA purposes. Banks that do not opt-in to the final rule at the earliest possible date may use the general risk-based capital rules or the Standardized Approach for their transitional floor calculations.

Table 1

Transitional Floor Period	Transitional Floor Percentage
First Floor Period	95 Percent
Second Floor Period	90 Percent
Third Floor Period	85 Percent

For core banks, and banks that opt in to the final rule at the earliest possible date, the transitional floors will be determined using the general risk-based capital rules without consideration of any changes to the risk-based capital rules that may be enacted by the Standardized Approach.

Interagency Study

The Agencies have implemented an important safeguard in the final rule. Under the final rule, the Agencies will jointly evaluate the effectiveness of the new capital framework. The Agencies will issue a series of annual reports during the transition period that will provide timely and relevant information on the implementation of the Advanced Approaches. In addition, after the end of the second transition year (after 2010), the Agencies will publish a study (interagency study) that will evaluate the Advanced Approaches to determine if there are any material deficiencies. For any primary federal supervisor to authorize any bank to exit the third transitional floor period, the interagency study must determine that there are no such material deficiencies that cannot be addressed by then-existing tools, or, if such deficiencies are found, they must be first remedied by changes to regulation. Notwithstanding the preceding sentence, a primary federal supervisor that disagrees with the finding of material deficiency may not

authorize a bank under its jurisdiction to exit the third transitional floor period unless it first provides a public report explaining its reasoning.