Regulatory Alert

Regulatory Insights for Financial Services

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Capital Requirements: Proposed “Basel III Endgame” & GSIB Capital Surcharges

KPMG Insight:

- *The “Basel III Endgame” focuses on capital held against credit, operational, market and credit valuation adjustment risks. Amendments are meant to:*
  - *Introduce a more transparent and consistent framework for measuring risk-weighted assets.*
  - *Apply to all banking organizations subject to Category I to IV capital standards with more than $100 billion in assets.*
  - *Standardize the Risk Weighted Assets (RWA) approaches for Credit Risk and Operational Risk.*
  - *Increase the “risk sensitivity” of regulatory capital measures and overall regulatory capital requirements, especially for banking organizations with high-leverage / private equity exposures, re-securitization, and large trading activities.*
  - *Encourage the banking organizations to re-assess their business and investment strategies to comply with the new capital requirements and further ‘optimize’ their balance sheets.*
- *Implementation and compliance of the proposed rules is anticipated to require a multi-year effort in such areas of governance, data, models, system infrastructure, internal controls, regulatory reporting, and capital strategies, and will span business lines and corporate functions. Companies should conduct a current-state assessment and quickly look to establish centralized coordination to drive the various transition efforts.*

The Federal Reserve Board (FRB), Office of the Comptroller of the Currency (OCC), and Federal Deposit Insurance Corporation (FDIC) (collectively, “agencies”) issue a joint Notice of Proposed Rulemaking that would revise the bank capital requirements. The revisions would be generally consistent with changes to the international capital standards issued by the Basel Committee on Banking Supervision, which have been generally referred to as the “Basel III Endgame”.

The proposal would apply to firms with at least $100 billion in total assets and to smaller firms with “significant” trading activities. It would require firms to use standardized approaches to credit, market, and operational risk exposures.

In a separate action, the FRB proposes amendments to its rule that identifies and establishes risk-based capital surcharges for global systemically important bank holding companies (GSIBs). The amendments are intended to improve measurement of the ‘systemic indicators’ under the GSIB surcharge framework and to enhance the sensitivity of the surcharge to changes in a bank holding company’s risk profile.

Highlights of the proposals follow.

Proposed Revisions to Capital Requirements: “Basel III Endgame”

The agencies have proposed numerous changes, including:

Scope of Application. The proposal would apply to banking organizations with:

- Total assets of $100 billion or more and their subsidiary depository institutions (including Category I, II, III, and IV organizations).
- 'Significant trading activities', based on $5 billion of trading assets plus trading liabilities (calculated on four-quarter averages).

Credit Risk.
The proposal would adopt expanded risk-based approach for setting regulatory capital requirements for credit risk. The stated goal of this change is to increase granularity, robustness, transparency, and comparability of the credit risk capital framework, address regulatory concerns around internal models used for minimum capital requirements for credit risk, and improve risk capture for certain off-balance sheet exposures

Key Changes	
Expanded risk-based approach for credit risk exposures.	— Apply the same treatment and definitions for many credit risk exposure categories as under the existing capital rule. — Introduce new definitions for defaulted exposures and defaulted real estate exposures. — Be more "risk-sensitive" by including additional criteria and metrics that enable differentiation of credit risk within exposure categories and allows for application of a broader range of risk weights (e.g., exposures to depository institutions, foreign banks, and credit unions, subordinated debt (including GSEs'), real estate, retail, and corporate exposures. — Apply the standardized approach for counterparty credit risk to banking organizations subject to Category III and IV standards. — Address equity exposures, securitizations, and credit risk mitigation.

Market Risk.
The proposal seeks to improve 'risk-sensitivity', calibration, and consistency of internal models use for market risk capital requirements.

Key Changes	
Standardized and Internal Model Approaches for calculating RWAs for market risk.	— Consist of three primary components under the Standardized Approach: - A sensitivities-based method capital requirement (non-default market risk associated with certain risk factors). - A standardized default risk capital requirement (losses on credit and equity positions in the event of issuer default). - A residual risk capital requirement (other known risks, such as gap risk, correlation risk, and behavioral risks). — Replace the VaR-based measure of market risk in the existing capital rule with a measure based on expected shortfalls under the Internal Model Approach. — Provide for enhanced "risk-sensitivity" by introducing the concept of a trading desk under the models-based measure for market risk to the trading desk level. — In limited instances to specific positions: - 1) Fallback capital requirement when an organization is unable to calculate market risk capital requirements under the sensitivities-based method or the standardized default risk capital requirement. - 2) Capital add-on for re-designations when an organization re-classifies an instrument after initial designation as being subject either to the market risk capital requirements or to the capital requirements of the capital rule - 3) Any additional capital requirement established by the primary federal supervisor.

Operational Risk.
The proposal introduces a standardized approach for measuring operational risk that would be applicable to all large banking organizations; it is intended to increase 'transparency, comparability, and certainty'.

Key Changes	
Standardized approach to measuring operational risks.	— A function of an organization's "business indicator component" and "internal loss multiplier". - Business indicator component: an organization's business volume (based on activities included in the financial statements such as lending and investment activities and fee and commission-based activities) and 'scaling factors'. - Internal loss multiplier: a ratio of historical operational losses and the business indicator component. Would increase operational risk capital requirements as historical operational losses increase.

Adjusted Credit Valuation Adjustment (CVA) Requirements.
The proposal would require organizations subject to the CVA risk-based requirements to reflect in RWAs the potential losses resulting from increases of CVA for most OTC derivative contract counterparties.

Key Changes	
Introduces a new, standardized approach for measuring CVA risk.	— Two approaches for measuring CVA risk: - 1) Basic approach (similar to the existing capital rule's simple CVA approach). - 2) Standardized approach, to allow organizations to recognize hedges for the expected exposure component of CVA risk.

Alignment. The proposal would "align" the definition of capital and calculation of regulatory capital across Categories I, II, III, and IV. In particular, banking organizations in Category III and Category IV would be required to:

- Recognize most elements of AOCI (accumulated other comprehensive income) in regulatory capital (consistent with Category I and II).
- Apply the capital deductions (e.g., mortgage servicing assets, certain temporary difference deferred tax assets) and minority interest treatments (consistent with Category I and II).
- Apply total loss absorbing capacity (TLAC) holdings deduction treatments.

Supplementary Leverage Ratio and Countercyclical Capital Buffer. The proposal would apply 1) the supplementary leverage ratio requirement, and 2) the countercyclical capital buffer, to Category IV organizations.

Dual-Requirement Structure. The proposal would require calculation of risk-based capital ratios under both the new "expanded risk-based approach" and the "standardized approach" using the lower of the two for each risk-based capital ratio.

Comment Period and Proposed Compliance Date.

- The agencies are soliciting public comment on the proposed rulemaking, with a submission deadline of November 30, 2023.
- The proposal also includes a three (3) year transition period for compliance, with a proposed compliance date for the final rule of July 1, 2025.

FRB Proposal on Risk-Based Capital Surcharges

The FRB proposes amendments to 1) its rule that identifies and establishes risk-based capital surcharges for global systemically important bank holding companies (GSIBs) and 2) to the Systemic Risk Report (FR Y-15). The changes are intended to improve the measurement of 'systemic indicators' under the GSIB surcharge framework and enhance the sensitivity of the surcharge to changes in the bank holding company's risk profile.

The proposal would:

- For certain 'systemic indicators' currently measured as of single date: Change reporting of the average of daily or monthly values to reduce the effects of temporary changes to indicator values around measurement dates.

- Amend certain 'systemic indicators' within the "interconnectedness, complexity, cross-jurisdictional activity, substitutability, and short-term wholesale funding categories".
- Reduce 'cliff effects' and enhance the sensitivity of the surcharge to changes in method 2 scores by calculating surcharges based on narrower score band ranges.
- Amend the Systemic Risk Report (FR Y-15).

Comment Period and Proposed Compliance Date.

- The FRB is seeking public comments on the proposed amendments, with a deadline for submission of November 30, 2023.
- Proposed amendments to the capital rule and FR Y-15 would take effect two calendar quarters after the "date of adoption" of a final rule.

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