Reg News

Basel III Endgame

NPR Ushers In a New Era

US Regulators Issue Basel III Endgame: NPR Ushering In a New Era for Capital Management and Reporting

Scope

- The long-awaited US Federal Reserve's NPR issued on July 27, 2023, encompasses significant changes across all pillars of regulatory capital risk measurement including credit, market, operational risks, and CVA.
- The new dual-requirement framework, illustrated in the NPR's diagram displayed below, introduces the expanded risk-based approach (ERBA) conceptually doubling the need for computation, analytics, and reporting.
- The scope of firms deemed complex enough for the new dual-requirement framework has broadened to include Categories III and IV Regional Banks and IHCs.

Capital Measurement

- Thematically, the US has shifted away from modeled approaches in favor of increasing risk sensitivity and standardization. And while modeled approaches are still allowed for Market Risk, there are new complexities limiting the ability of firms to attain model approvals across desks.
- Credit Risk charges have become more substantial with material changes to risk weights and changes to existing definitions (e.g., Real Estate) and methodologies (e.g., SA-CCR, SFTs, Equity In Funds, Securitizations).
- The new Market Risk requirements are significant both for modeled and standard approaches and can have meaningful impacts on banks' operating models. All in-scope banks must perform Standardized Market Risk calculations, which will require tight integration with middle-office and risk systems to produce the risk sensitivities required for accurate regulatory calculations across risk-asset classes, and buckets.
- The Standardized Operational Risk Rule has conformed to international standards and is now more uniform across firms anchored by historical loss data and business volume but is data and computationally intensive.
- There are limitations on eligible capital instruments (e.g., DTAs, MSA, Minority Interest).

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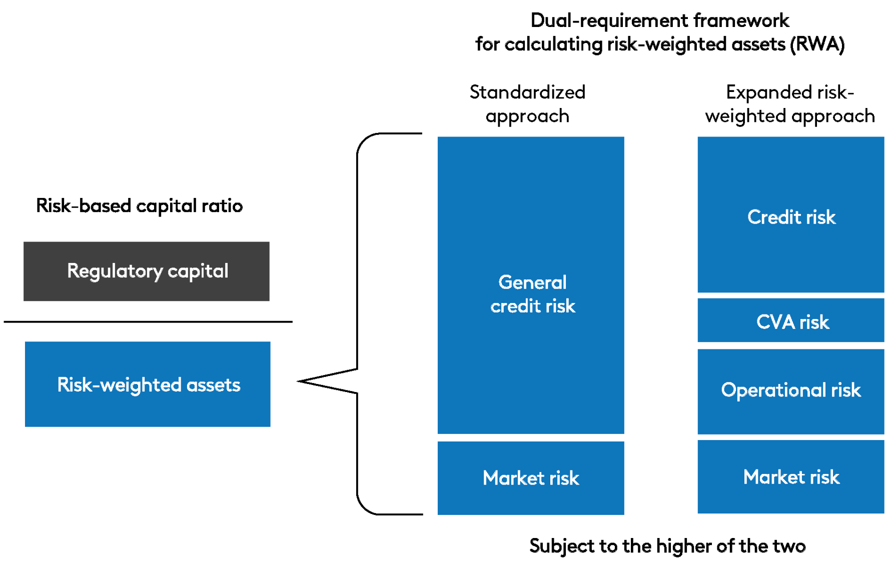
Reporting

- Regulatory reporting changes are yet to be fully defined, but based on existing guidance and proposed draft changes, material rewrites to a wide array of reports are to be expected.
- Enhanced public disclosure requirements include qualitative and quantitative substantiation.

Standardized Approach and Expanded Risk-Based Approach

Banking organizations subject to the expanded risk-based approach would calculate two risk-weighted asset amounts and be subject to the higher of the two.



Source: Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation. "Interagency Overview of the Notice of Proposed Rulemaking for Amendments to the Regulatory Capital Rule Applicable to Large Banking Organizations and to Banking Organizations with Significant Trading Activity." Released on July 27, 2023

Bank Capital in Focus

- Unlike years past, banks find themselves paying closer attention to regulatory capital due to downward movements in equity prices, increases in ALLL (Allowance for Loan and Lease Losses) and NCO (Net Charge-Off), and overall economic uncertainty.
- Proposed changes to the treatment of AOCI (Accumulated Other Comprehensive Income) will, over the coming transition period, add to the pressure on banks' capital ratios.
- Reporting changes are proposed for FR Y-14 Schedule A.1.d.

Credit Risk in Focus

- The NPR has shifted toward international standards for credit risk-weighted assets and adopted numerous fundamental changes.
- Risk weights, risk weight segmentation, calculation methodologies, and required data granularity all have changed significantly.
- Banks must thoroughly reassess the comprehensiveness of existing policies, data pipelines from systems of record, and definitions within operational data sources.
- Reporting changes are proposed for FR Y-9C, FR Y-14Q, Schedules A and H, as well as FR Y-14M, Schedules A, B, and D and we expect significant changes to FFIEC 101.

Market Risk in Focus

- The NPR is adopting a Standardized Approach to Market Risk that is roughly equivalent to the fundamental review of the trading book (FRTB) standardized measure for market risk (SA-MR), a BCBS and international standard.
- Many, if not all large banks likely will favor the IM (Internal Model) method as the potential RWA (Risk-Weighted Assets) savings can be material.
  - However, banks will need to set up a new model validation process including supervisory trading desk-level approach, with a specific focus on tail risk and illiquid positions considering recent market events.
  - In addition, the desk-centric approach could mute the offset benefits and diversification effect unless banks attain model approvals for all desks.
- Notably, the Market Risk rules also apply to firms with less than $100B in total assets if they meet one of the following criteria: Trading Assets + Liabilities >5B OR Trading Assets + Liabilities > 10% of Total Assets.
- Reporting changes are proposed for FR Y-14 Schedule A.1.c.1 and we expect significant changes to FFIEC 102.

CVA in Focus

- Banks must now compute the Credit Valuation Adjustment (CVA) as a required capital charge under the basic approach (BA-CVA) or the standardized approach (SA-CVA).
- While BA-CVA can greatly simplify compliance, banks seeking to benefit from hedges to the exposure component of CVA will favor the SA-CVA but will need to obtain regulatory approval to calculate CVA on that basis.

Operational Risk in Focus

- Firms must now quantify operational risk based upon actual historical loss data and business volume.
- Increased occurrences of operational risk incidents (e.g., cyber risk) have provided ample basis for a more quantitative, data-driven approach to operational risk.
- Firms must compute the BIC (Business Indicator Component) as derived by three sets of income-based factors and the ILM (Internal Loss Multiplier) based on the average annual operational losses of the prior 10 years at an impact level.
- Reporting changes are already proposed to FR Y-14Q Schedule E reporting.

Timing

- Comments are due by November 30, 2023, with a final rule potentially ready as early as January 2024.
- Go-live is proposed for July 2025 with a transition provision for certain changes from July 2025 through July 2028.
- Although initial views on reporting changes have been incorporated into the NPR, significant changes are still to come.

As a result, banks must approach capital measurement with a balanced need to move rapidly, comply accurately, and optimize regulatory capital. Distinct workstreams focused on all the impacted pillars – policy, data strategy, technology, risk management, internal/external reporting – must be mobilized quickly with executive oversight, to ensure the best outcome.

While the Basel III Endgame is just beginning in the US, Adenza has successfully implemented Basel IV on an international basis going live in 2023 for G-SIB clients.

Contact Adenza to start a conversation about how we can help with your Basel journey.

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