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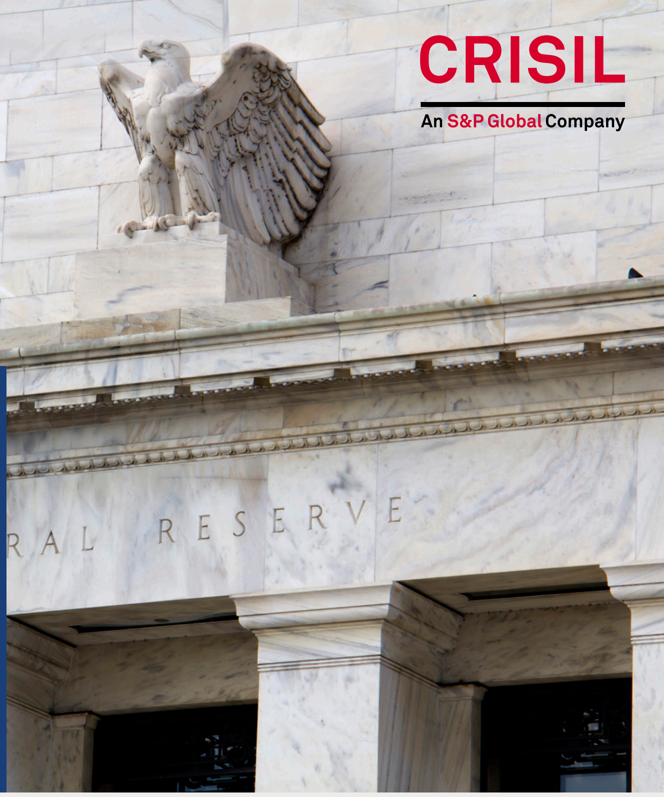

Barr speech on Basel III Endgame

Proposed changes and CRISIL's view

Reworking the US Basel III Endgame

Michael Barr, Vice Chair for Supervision, the US Federal Reserve, gave a speech on Tuesday, September 10, 2024, in response to the proposed draft US capital rules, known as the US Basel III Endgame, jointly published by the Fed, the Office of the Controller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) in July 2023.

These rules are based on the minimum capital standards recommended by the Basel Committee on Banking Supervision (BCBS) and the capital surcharge required by the eight globally systemically important banks (G-SIBs) in the US.

Barr highlighted the key proposals before the Fed board.

The original draft proposed significantly higher capital requirements for banks, leading to a barrage of public comments.

In response, Barr has proposed a second draft which is expected after Fed board approval. Both drafts will be open for public comments and feedback for two months after which the final US capital rules will be published.

Once finalised, banks will have one year to comply with Phase I of the implementation.

We highlight Barr's second draft proposals here.

Proposed changes

- The estimated increase in capital requirement is 9% for G-SIBs, compared with 19% based on the previous draft
- Category 1 banks will be subject to new credit risk and operational risk requirements, and revised frameworks for market risk and credit valuation assessment (CVA)
- The estimated increase in capital requirements is 3 to 4 percent for Category 2 banks
- For Category 3 and 4 banks still subject to these rules, the estimated increase in capital requirements is 0.5 percent
- There are new credit risk and operational risk requirements. Those market risk and CVA frameworks engaging in significant trading activity applicable to Category 3 firms will revert to the simpler definition of capital
- For Category 4 banks, a simpler capital framework would be applied, and they would be subject to only unrealised losses on securities

Credit risk

- Reduced risk-weighted assets (RWA) for real estate (for mortgages, up to 90% of the loan to value [LTV] ratio) and retail exposure (credit exposures with a small portion of the commitment line and no pre-set credit limits)
- Lowered corporate RWA for regulated entities having low-risk corporate debt and thus covering both publicly and non-publicly traded, investment-grade corporates
- Eliminated minimum haircut for SFTs

Equity risk

- Reduced RWA for tax credit funding structure

Operational risk

- For firms, this will not be based on operational loss history, which will reduce the fluctuations in operational risk and capital requirement over time
- For fee-based activities, net income instead of gross revenue will be used to calculate operational risk capital
- For investment management activities, operational risk capital requirement is reduced

Market risk

- Multiyear implementation period for profit and loss attribution tests
- Additional adjustments to improve incentives for a firm to model its exposures
- Uniform mortgage-backed securities' positions would be treated as having a single obligor
- Reduce the capital required for the client-facing leg of a client-cleared derivative

Changes proposed to the G-SIB surcharge

- Alterations proposed to the capital requirements related to client clearing will not be adopted
- Effects of inflation and economic growth to be considered when measuring the systemic risk profile of G-SIBs
- 'Cliff effects' to be reduced by calculating G-SIB capital surcharge in 0.1% increments instead of 0.5%

Our view

- Reduced credit risk RWA will increase the lending capacity of banks
- The readiness of firms to implement the changes in time will be tested. Banks should be ready to implement Phase 1 of the changes within one year. It will be a massive undertaking, and challenges will arise, such as from data gathering and management, technology building, process re-engineering and people hiring
- The rules will have a direct impact on the competitive advantage of global banks in the US jurisdiction compared with other jurisdictions
- Banks and regulators are looking at newer activities, and risks such as crypto, cyber, climate risk, geopolitical and sovereign
- The largest impact will be on the trading desk because the increased capital requirement will likely result in sharper focus on market risk models. This can impact trading activity and increase scrutiny of models

CRISIL's value proposition

SME engagement : Deep domain and regulatory knowledge, analytical rigour and effective execution of our talent pool. Expertise across risk types, enabling interpretation of capital rules under US jurisdiction, and providing SME engagement across businesses to ensure smooth transition to the new US capital rules.

Impact analysis: Experts with hands-on knowledge to run impact analysis and perform testing; advisory to optimise the capital impact

Governance framework : Set up a well-designed governance framework to navigate through the compliance journey and interpret regulations for robust deployment and execution

Data and technology enhancement: Set up dedicated workstreams for data discovery and sourcing, assess and provide guidance to invest in suitable data and technology requirements

Gap analysis: Review and identify gaps required to implement capital requirement under US capital rules across risk types for firms, develop plans to address the gaps requiring significant efforts, appropriate resource allocation and experience

Operational efficiency: Review operating models for all the risk functions, designate relevant SMF role(s), in the process of implementing US capital rules for effective oversight across teams

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