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# Basel III: Issues and implications

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# Preface

In the aftermath of the financial crisis of 2008–2009, the Basel Committee of Banking Supervision (BCBS) embarked on a program of substantially revising its existing capital adequacy guidelines. The resultant capital adequacy framework is termed 'Basel III,' and the G20 endorsed the new Basel III capital and liquidity requirements at their November 2010 Summit in Seoul. There are many areas of detail needing further development, and worldwide debate and lobbying will inevitably continue—most notably in relation to the whole issue of systemically important financial institutions (SIFIs). The core principles, however, are set, and complying with the Basel III framework is inevitable.

With the core framework being adopted by the national authorities, the focus of attention is now shifting towards implementation—determining business impact and planning for compliance. There are strong indications that even though the framework in principle is being adopted, actual implementation will become divergent across various jurisdictions. Although the transitional period appears long, the 2019 deadline to complete implementation should not distract institutions from the need to demonstrate capital and liquidity resilience much earlier and meet interim deadlines along the way.

Despite a lack of absolute clarity, it would not be worthwhile to wait until all ambiguities have been resolved. Prior experience with the Basel II framework has shown that early analysis, strategic evaluation, and robust planning are all crucial to success in the ultimate implementation. Firms must also remain flexible to adapt to subsequent changes and developments.

This document attempts to summarize the key details of the Basel III capital adequacy framework and explores some of the practical implications and considerations for firms to establish an effective and efficient implementation procedure.

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# The background to a discussion on Basel III

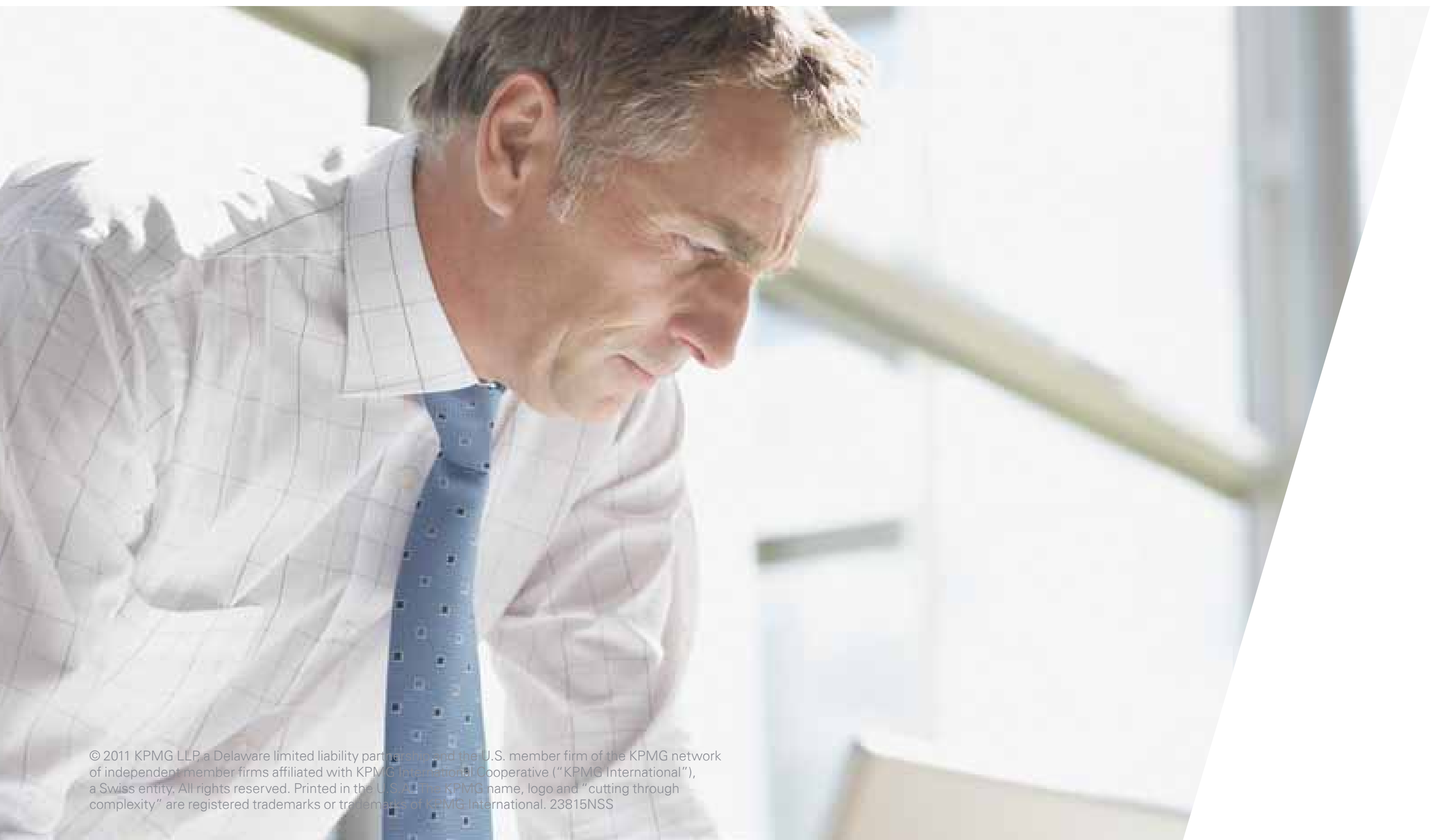
The global economic crisis has provided an opportunity for a fundamental restructuring of the approach to risk and regulation in the financial sector. The Basel Committee on Banking Supervision (BCBS) has collectively reached an agreement on reforms to "strengthen global capital and liquidity rules with the goal of promoting a more resilient banking sector," which is being referred to as "Basel III." Under Basel III, each area of proposed changes has a separate consultation, debate, and implementation phase. As a result, compared with the implementation of the previous agreement (Basel II), this enhanced level of dynamism, complexity, and interdependency within the global regulatory landscape will likely add significant challenge to the implementation of Basel III.

The recent G20 Summit in Seoul endorsed the Basel III agreement. The G20 also endorsed very long transitional periods for full implementation of the Basel III capital and liquidity proposals.

Despite the G20's objective of establishing a level playing field for banks, the reality is that regulators in different national jurisdictions are taking different paths over key issues like governance and remuneration, taxes and levies, the treatment of systemically important institutions, the so-called "living wills," the scope of supervision, and even accounting and disclosure.

This is partly driven by different starting points in terms of the impact on countries of the financial crisis, yet there remains underlying tension around the trade-off between safety within the financial system and its ability to support economic growth.

The risk and regulatory reform agenda represented by Basel III needs also to be examined in light of the global journey back towards financial stability. The need is for a set of guidelines that will mutually reinforce the stability of financial institutions' fiscal soundness of the economies in which they operate.



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# What are the key outcomes?

As part of the general high-level agreement on the proposals, regulators from various national jurisdictions made a significant compromise on the time line for implementation of the framework, as well as various areas of implementation, including the treatment of minority interests, Deferred Tax Assets, and the calibration of the leverage ratio, which were the subject of intense debate among the BCBS and banks. Other key items, such as how to deal with SIFIs (systemically important financial institutions, a.k.a. "Too Big to Fail"), have been deferred for implementation due to lack of agreement.

Similarly, there were some intense discussions on the increase in the common equity tier 1 ratio from 2 percent to **4.5 percent**. This appears to be less than what some policy makers had hoped for. However, the implementation of the proposals will be a challenge. While many banks already have ratios above 4.5 percent, these are based on Basel II requirements. The changes mandated by Basel III are expected likely to cause even well-capitalized banks in Europe and the United States to find it hard-pressed to be compliant. This could even result in reduced credit availability or increased cost of credit overall.

National regulators from various geographical areas have disagreed over the implementation of Basel III. Those in the West are focusing on the need for increased buffers (both capital and liquidity), while those in the East are focusing on comprehensive coverage of risk management, enhanced stress testing, and the need for risk and capital management to align and be a core part of a firm's strategy. The international divergence over implementation has led to a framework where supervisory discretion will influence detailed implementation and leaves scope for some jurisdictions to apply a more rigid interpretation of Basel III than elsewhere. Political issues and debate around implementation will tend to induce an ongoing fear of an uneven playing field going forward.

There are also as yet no detailed proposals for capital or liquidity for SIFIs. While the Federal Reserve Board has developed general principles, it is unclear how these will operate in practice. This is one area where the lack of a level playing field will likely become apparent as different jurisdictions are likely to adopt the rules inconsistently for domestic SIFIs.

A phased-in time line has been agreed by the BCBS, but in some markets, there is a trend, spurred on by regulators and market analysts, for some banks to set ambitious compliance deadlines. For banks, they see early implementation as a competitive advantage, a way of demonstrating their soundness, not only to the regulators, but also to the market. The reputational risk of being perceived as a laggard is too great to ignore. This should also spur the competitors to implement the framework as early as possible.

Under the new framework, common equity requirements are more than double as before, leading to significant reduction of eligible capital. There is also the possibility of significant increase of the firm's risk-weighted assets, depending on the firm's circumstances. The combination of additional capital requirements and higher charges will, in all probability, cause some negative impact on return on equity, the level of which will depend on individual operating models.

The requirements will possibly have a fundamental impact on business models and the shape of the business done by banks. Some commentators fear the potential to return to a regime similar to the one that operated a century ago in which there was limited competition (caused by crowding out of the smaller banks) and much less innovation in financial services.

Alongside the proposals for increased regulation in the areas of capital and liquidity is a debate around the degree of intensity of supervision that supervisors apply to institutions. Enhanced supervisory practices likely are expected to be a major focus of the BCBS in 2011. The choice of national regulators to prioritize the pressurizing banks to change their business models as a way to drive structural change or to enhance their supervisory efforts to ensure that economic failures are contained, likely are expected to have a huge impact on individual financial institutions.

Amidst all of the debate on the new proposals, it is worth noting that the fundamental approach introduced by Basel II for determining credit risk-weighted assets through internal models has not changed. As with Basel II, Basel III remains a 'risk-based' capital regime. Banks should therefore keep in mind that regulators will continue to focus on risk management and governance in underpinning a robust financial sector. Those that do not are likely to find themselves subject to even greater requirements and scrutiny.

One vexing aspect in the implementation of Basel III in the United States is the conflict with article 939A of the Dodd-Frank Act, which requires the Federal Reserve Board to review and remove references to credit ratings. Also in the picture is the requirement that banks' proprietary trading capital be reduced to a significant portion of the tier 1 capital.

Successful implementation and response must start early, and many institutions have already begun this process in light of the framework now agreed. However, it is very unlikely that Basel III will be the answer to all the problems. Institutions must therefore retain flexibility to accommodate years of fine tuning and future reforms.

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# A summary of qualitative impacts of the proposals

## Impact on individual banks

### Weaker banks crowded out
Under adverse economic conditions, with regulatory scrutiny ever more intensive, the weaker banks will likely find it more difficult to raise the required capital and, funding, leading to a reduction in different business models and, potentially, in competition.

### Significant pressure on profitability and ROE
Increased capital requirements, increased cost of funding, and the need to reorganize and deal with regulatory reform will put pressure on margins and operating capacity. Investor returns will likely decrease at a time when firms need to encourage enhanced investment to rebuild and restore buffers.

### Change in demand from short-term to long-term funding
The introduction of two liquidity ratios to address the short- and long-term nature of liquidity and funding will likely drive firms away from sourcing shorter-term funding arrangements and more towards longer-term funding arrangements with the consequent impact on the pricing and margins that are achievable.

### Legal entity reorganization
Increased supervisory focus on proprietary trading, matched with the treatment of minority investments and investments in financial institutions, is likely to drive group reorganizations, including M&A and disposals of portfolios, entities, or parts of entities, where possible.

## Impact on the financial system

### Reduced risk of a systemic banking crisis
The enhanced capital and liquidity buffers, together with the focus on enhanced risk management standards and capability, should lead to reduced risk of individual bank failures and reduced interconnectivity between institutions.

### Reduced lending capacity
Although the extended implementation time line is intended to mitigate the impact, significant increases to capital and liquidity requirements may lead to a reduction in the capacity for banking activity or, at the very least, a significant increase in the cost of provision of such lending.

### Reduced investor appetite for bank debt and equity
Investors may be less attracted by bank debt or equity issuance given that dividends are likely to be reduced to allow firms to rebuild capital bases, ROE and profitability of organizations will likely decrease significantly, and some of the proposals on non-equity instruments (if implemented) could start to make debt instruments loss-absorbing prior to liquidation for the first time. This will become evident through investor sentiment in the cost of new capital issuance and the interbank lending rate.

### Inconsistent implementation of the Basel III proposals leading to international arbitrage
If different jurisdictions implement Basel III in different ways, issues we saw under Basel I and Basel II with respect to international regulatory arbitrage may continue to disrupt the overall stability of the financial system.

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# Quantitative impacts of the proposals

The enhanced capital ratios prescribed by the BCBS relate to the ratio of a firm's eligible regulatory capital divided by a regulatory prescribed calculation of risk-weighted assets. As set out in the diagram below, all three parts of this have changed, putting more pressure on a firm's compliance with the ratio. The combination of tightening of requirements for inclusion in eligible capital with the increase in risk-weighted assets under the new rules has caused an increase in the capital ratio requirement.

As such, all elements of the capital ratio are affected by the Basel III framework.

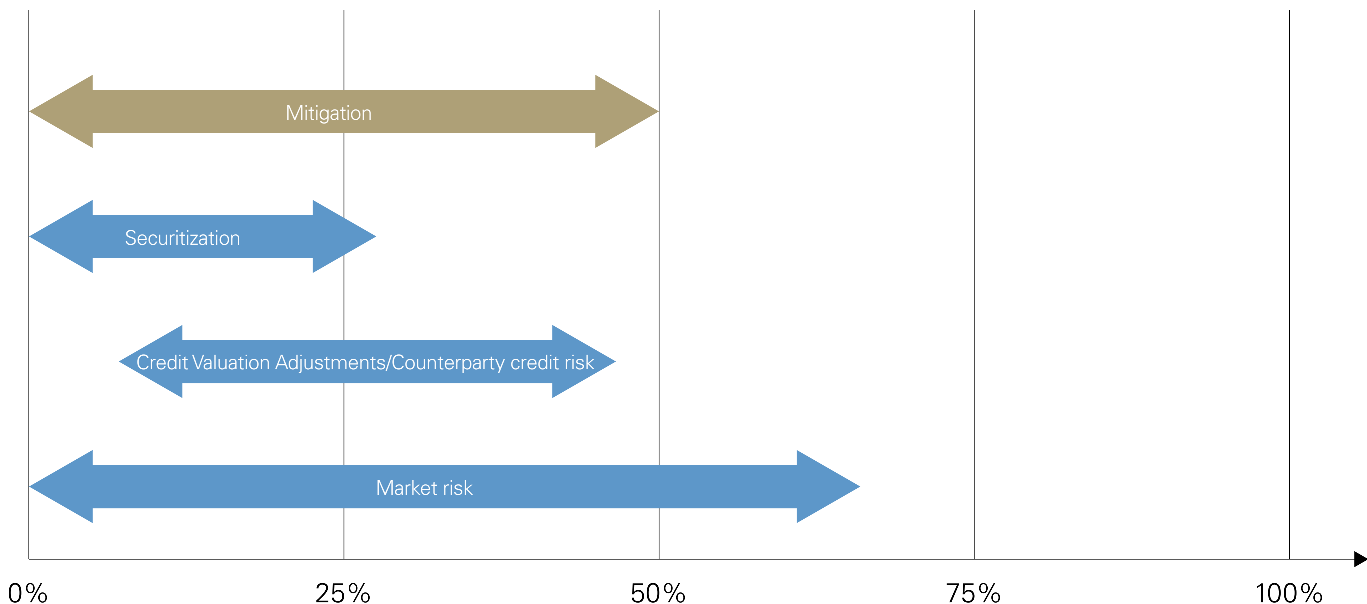
$$\text{Capital ratio} \uparrow = \frac{\text{Eligible capital} \downarrow}{\text{Risk–weighted assets} \uparrow}$$

While much is firm-specific, estimates of the impact on the eligible capital forecast as much as a 60 percent[1] reduction arising from the changes to the deductions from capital for items such as minority interests, investments in financial institutions, and deferred tax.

Managing the potential increase to the RWA figure in the denominator is also crucial to mitigating the impact of Basel III on a firm's portfolios. It is very difficult to estimate for each firm, but the diagram below shows the possible percentage range of increases to the RWA arising from three of the key capital changes in Basel III, together with some estimate of the percentage range of mitigation of the potential RWA increase that many believe might occur.[2]

In addition, firms face shortfalls in their long-term funding needs of up to 50 percent [3] as a result of the new Net Stable Funding Ratio (NSFR) liquidity proposals.[4]

## Percentage range of potential increases to RWAs and the percentage range of possible mitigation to the RWA increases that might arise from key capital changes




[1] Range of estimates taken from various broker reports (Summer/Autumn 2010).

[2] Range of estimates taken from various broker reports (Summer/Autumn 2010).

[3] Range of estimates taken from various broker reports (Summer/Autumn 2010).

[4] N.B. The NSFR liquidity proposal is subject to revision as the Basel III proposals have been finalized.

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## Responses of banks to mitigate the impacts on capital ratio

Firms are hoping to be able to mitigate the impact on capital ratios through a variety of measures, including:

- **Improving the performance of existing assessment methodologies in internal ratings-based credit risk approach and internal models market risk approaches**

  The additional capital ratios in Basel III will likely amplify any inefficiency in existing internal modeling approaches to determining credit risk and market risk RWAs. Firms can therefore benefit from a thorough review of current methods and any associated conservatism, together with a review of the data, inputs, and systems that are used to populate such models.

- **Legal entity reorganization to optimize the impact of capital deductions**

  Changes to the treatment of minority interests and investments in financial institutions within the definition of capital may encourage firms to withdraw from certain entities, dispose of certain stakes, or buyout minority interest positions to optimize the capital calculation.

- **Active balance sheet management and hedging strategies**

  Pressure on bank capital has driven investment in active capital management and active portfolio management as banks review existing trades and consider how external protection, restructuring into other entities, or development of structured vehicles with investment from external third-party capital may help in minimizing or hedging counterparty and market risk exposure.

- **Redesign of business model and portfolio focus**

  Some types of business (particularly in the trading book) will likely see significant increases in RWAs and, therefore, capital. Firms will continue to review portfolio strategy and exit or reprice certain areas of the business that which become unattractive on a returns basis.

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# Basel III objectives and time lines

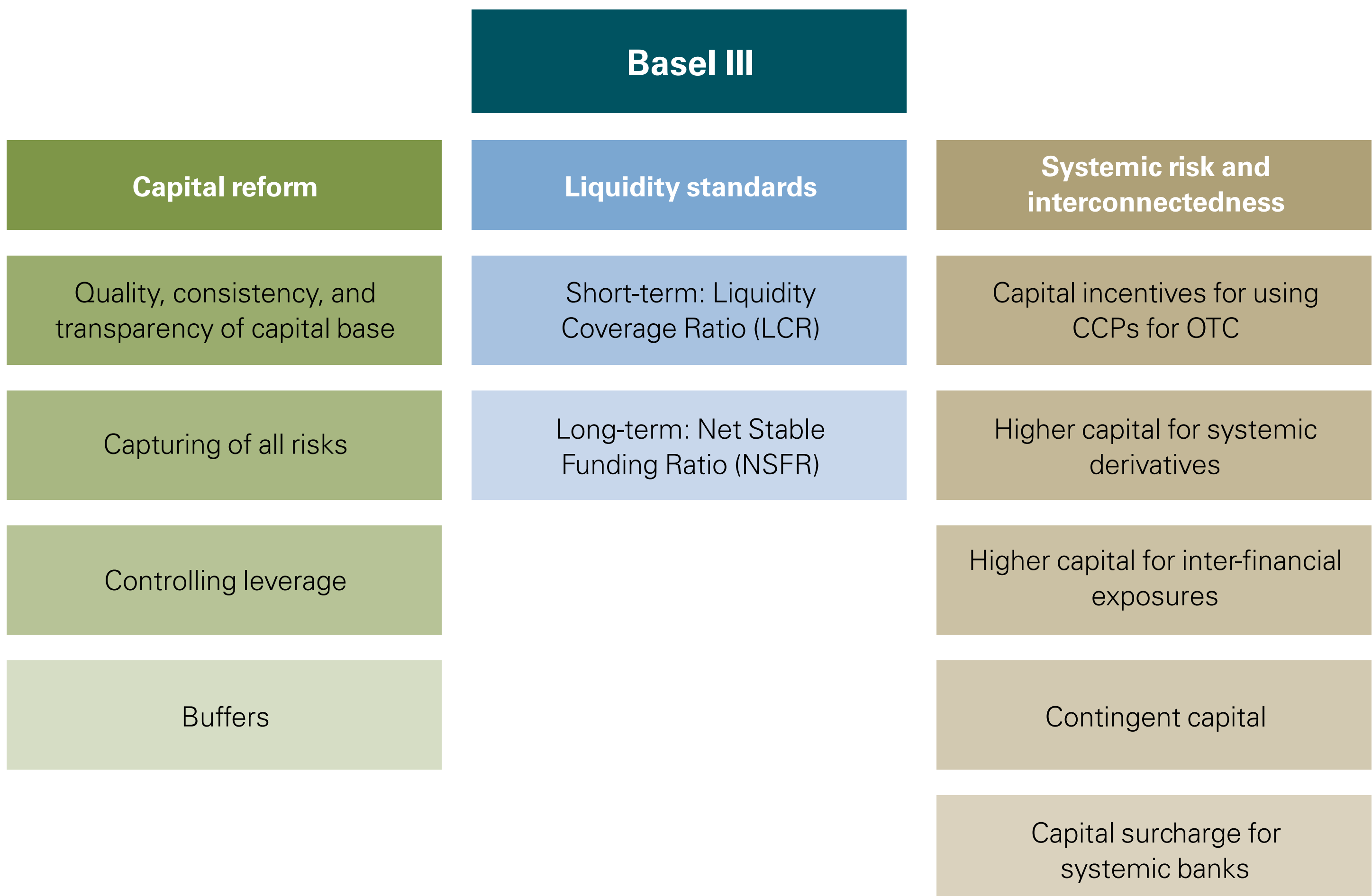
According to the BCBS, the Basel III proposals have two main objectives:

- To strengthen global capital and liquidity regulations with the goal of promoting a more resilient banking sector
- To improve the banking sector's ability to absorb shocks arising from financial and economic stress, which, in turn, would reduce the risk of a spillover from the financial sector to the real economy.

To achieve these objectives, the Basel III proposals are broken down into three parts on the basis of the main areas they address:

- Capital reform (including quality and quantity of capital, complete risk coverage, leverage ratio and the introduction of capital conservation buffers, and a counter-cyclical capital buffer)
- Liquidity reform (short-term and long-term ratios)
- Other elements relating to general improvements to the stability of the financial system.

## Breakdown of the Basel III proposals

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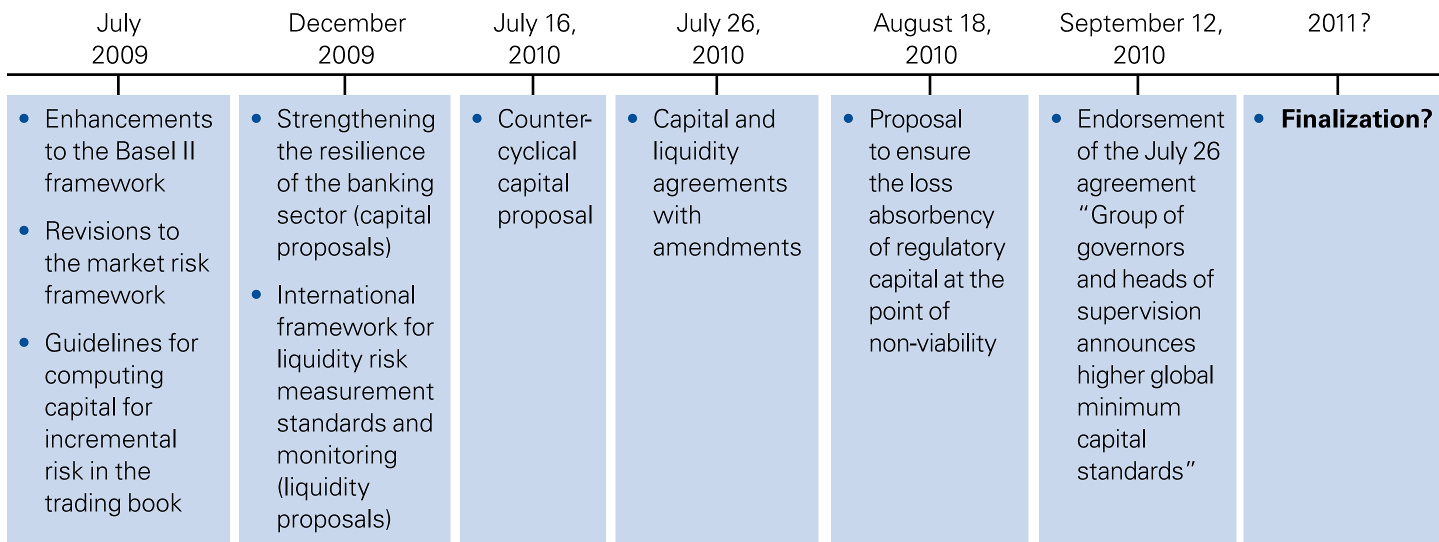
The Basel III proposals are incremental to the Basel 2.5 proposals published in July 2009 for which the FDIC and Federal Reserve Board have provided a joint notice of proposed rulemaking in January 2011. The Basel 2.5 proposals deal principally with the trading book and securitization positions.

The time line for agreement of the Basel 2.5 and Basel III proposals (see diagram below) has been extremely rapid compared with the agreement and implementation of the Basel II proposals over the period from 1999 to 2008.

## Time line for agreement of the Basel 2.5 and Basel III proposals




Source: KPMG analysis of BCBS, date.

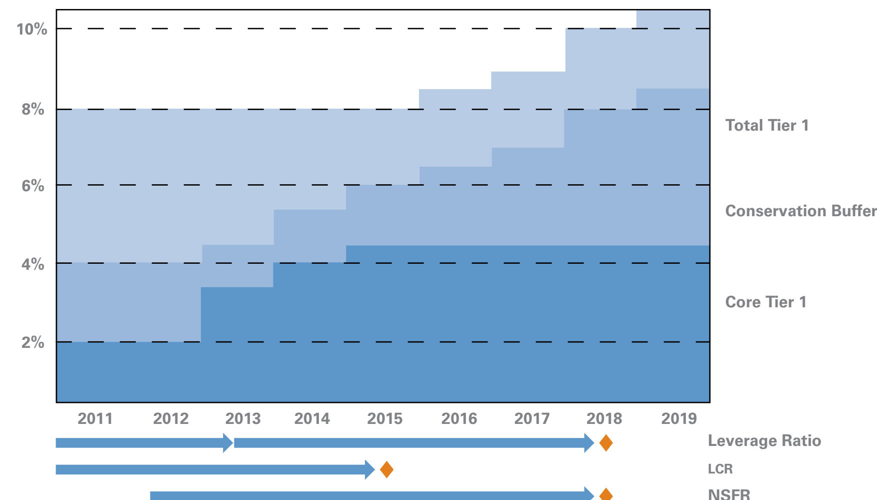
Many detailed elements of the Basel III package remain to be finalized in 2011, including the treatment of Credit Valuation Adjustments and SIFIs. The Basel III proposals will then need to be translated and implemented into national legislation.

The Basel III proposals are phased in over a period up to 2019, when full implementation will have been achieved, although many firms will need or seek to execute change at a much earlier stage. The phasing of each component part is set out in the diagram below.

NB – This excludes the implementation of:

- Any buffer for SIFIs. This might be 2–3 percent for domestic SIFIs and 5 percent or more for global SIFIs.
- The counter-cyclical capital buffer, which is still being designed. This is intended to require banks to raise capital requirements in the build-up to a credit boom as a buffer against the outcome of the credit boom.

## Phased implementation of the key Basel III components, excluding the possible buffers for SIFIs and counter-cyclical elements

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# Summary of the major Basel III recommendations and implications

The proposals are structured around the following areas, which we address in the series of tables below, highlighting the key changes and implications:

1. Increased quality of capital
2. Increased quantity of capital
3. Reduced leverage through introduction of backstop leverage ratio
4. Increased short-term liquidity coverage
5. Increased stable long-term balance sheet funding
6. Strengthened risk capture, notably counterparty risk

In the medium term, most firms will be capital and liquidity constrained and so will need to focus on capital management, product and business pricing, capital inefficiencies that remain from Basel II, and the structure of their liabilities. Given the rise in minimum capital ratios under Basel III, previous inefficiencies are amplified, and firms will need to address this issue. There is a greater incentive to move to the AIRB approach for credit risk, for example, as it would allow a more refined approach to calculating credit risk. Firms are also improving capital planning through aligning economic capital mechanisms with regulatory approaches.

| Regulatory objective – (1) Increased quality of capital | |
|---|---|
| Basel III contains various measures aimed at improving the quality of capital, with the ultimate aim to improve loss-absorption capacity in both going concern and liquidation scenarios. | |
| **Description of the key changes** | **Implications** |
| • Common equity and retained earnings should be the predominant component of Tier 1 capital instead of debt-like instruments, well above the current 50 percent rule. | • BCBS measures are already discounted by markets, so banks are likely to clean up their balance sheets as soon as possible. |
| • Harmonized and simplified requirements for Tier 2 capital with explicit target for Tier 2 capital. | • Likely to see raising of significant capital by banks, along with retention of profits and reduced dividends. |
| • Full deduction for capital components with little loss-absorption capacity such as minority interests, holdings in other financial institutions, Deferred Tax Assets. | • National regulators will have less flexibility to allow capital instruments to be included in Tier 1 or Tier 2 capital. |
| • Gradual phase-out of hybrid Tier 1 components, including many of the step-up/innovative/SPV–issued Tier 1 instruments used by banks over the past decade. | • Systemically important banks (and, potentially, all banks) may be allowed to issue contingent convertibles to meet additional capital requirements. |

| Regulatory objective – (2) Increased quantity of capital | |
|---|---|
| Basel III contains various measures aimed at increasing the level of capital held by institutions, as well as providing counter-cyclical mechanisms. | |
| **Description of the key changes** | **Implications** |
| Minimum common equity Tier 1:<br>• Increased from 2.0 percent to 4.5 percent<br>• Plus capital conservation buffer of 2.5 percent<br>• Bringing total common equity requirements to 7.0 percent<br>• To be phased in from 2013 to 2019<br>Minimum total capital:<br>• Increased from 8.0 percent to 10.5 percent (including conservation buffer)<br>• To be phased in from 2013 to 2019<br>Counter-cyclical capital buffer is being developed, which is expected to be implemented by increases to the capital conservation buffer during periods of excessive credit growth. | • Banks will face a significant additional capital requirement, and the bulk of this shortfall will need to be raised as common equity or otherwise by retaining dividends.<br>• In principle, banks will be able to draw on the capital conservation buffer during periods of stress, but it seems unlikely that they would choose to do so, given the associated constraints on their earnings distributions.<br>• Consequently, banks are likely to target a higher common equity ratio and the market expectation for common equity Tier 1 appears to be moving to approximately 9 percent<br>• There is likely to be further add-ons for Pillar 2 risks, systemically important firms, and the counter-cyclical capital buffer, so banks may target a total capital ratio of 13–15 percent. |

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## Regulatory objective – (3) Reduced leverage through introduction of backstop leverage ratio

The leverage ratio acts as a non-risk sensitive backstop measure to reduce the risk of a build-up of excessive leverage in the institution and in the financial system as a whole. The leverage ratio remains controversial, and there remains ambiguity about certain aspects of the exact mechanics.

### Description of the key changes

- The leverage limit is set as 3 percent, i.e. **a bank's total assets (including both on- and off-balance-sheet assets) should not be more than 33 times bank capital.**
- In 2011, reporting templates will be developed. In 2013, regulators will start monitoring leverage ratio data, and the ratio will be effective from January 2018.
- The ratio is introduced to supplement the risk-based measures of regulatory capital.
- The leverage ratio is implemented on a gross and unweighted basis, not taking into account the risks related to the assets.

### Implications

- The introduction of the leverage ratio could lead to reduced lending and is a clear incentive to banks to strengthen their capital position, although it remains to be seen whether the ratio will bite for individual firms.
- The non-risk-adjusted measure could incentivize banks to focus on higher-risk/higher-return lending.
- Pressure arises on banks to sell low margin assets (e.g., mortgages), which could drive down prices on these assets.
- Banks may be required by the market and the rating agencies to maintain a higher leverage ratio than required by the regulator.

## Regulatory objective – (4) Increased short term liquidity coverage

The regulatory response to the financial crisis has seen a long overdue rebalancing towards the importance of liquidity risk management and to complement its "Principles for Sound Liquidity Risk Management and Supervision", the Basel Committee has further strengthened its liquidity framework by developing two minimum standards for funding liquidity:

### Description of the key changes

- The 30-day Liquidity Coverage Ratio (LCR) is intended to promote short-term resilience to potential liquidity disruptions. The LCR will help ensure that global banks have sufficient high-quality liquid assets to withstand a stressed funding scenario specified by supervisors.
- For the LCR, the stock of high-quality liquid assets is compared with expected cash outflows over a 30-day stress scenario. The expected cash outflows are to be covered by sufficiently liquid, high-quality assets.
- Assets get a 'liquidity'– based weighting varying from 100 percent for government bonds and cash to weightings of 0 percent – 50 percent for corporate bonds.

### Implications

- The Risk of impact from a bankrun should be reduced, which would improve the overall stability of the financial sector.
- The introduction of the LCR will require banks to hold significantly more liquid, low-yielding assets to meet the LCR, which will have a negative impact on profitability.
- Banks will change their funding profile, which will lead to more demand for longer-term funding. This funding may not be available from institutional investors that generally seek to reduce their holdings in the financial sector.
- Interpretation of 'right' run-off rates by national regulators may cause level-playing field discussions.

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## Regulatory objective – (5) Increased stable long-term balance sheet funding

The Net Stable Funding Ratio (NSFR) is designed to encourage and incentivize banks to use stable sources to fund their activities to reduce the dependency on short-term wholesale funding.

### Description of the key changes

- The NSFR compares available funding sources with funding needs resulting from the assets on the B/S.
- Available stable funding > required stable funding.
- Required and available funding amounts are determined using weighing factors, reflecting the "stability" of the funding available and the duration of the asset.
- The weighing factors for assets vary from 0 percent and 5 percent for cash and government bonds, respectively to, 65 percent for mortgages, 85 percent for retail loans, and 100 percent for other assets.
- For determining stable funding available for liabilities, the weighing factors vary from 100 percent for Tier 1 capital to 90 percent for core retail deposits and 50 percent for unsecured wholesale funding. ECB funding is weighed at 0 percent.

### Implications

- The NSFR incentivizes banks to reduce their reliance on short-term wholesale funding and increase stability of the funding mix.
- Banks will need to increase the proportion of wholesale and corporate deposits with maturities greater than one year, but currently, the appetite for term debt is limited.
- For most banks, it will be difficult to increase the proportion of wholesale deposits with maturities greater than one year (limited market demand), which is likely to lead to higher funding costs.
- Managing the NSFR by altering the asset mix will likely result in an increase in the proportion of short-term assets, reducing yield.
- Stronger banks with a higher NSFR will be able to influence market pricing of assets. Weaker banks will see their competitiveness reduced, which will potentially decrease the level of competition.

## Regulatory objective – (6) Strengthed risk capture, notably counterparty risk

The BCBS seeks to ensure full coverage of risks in the Pillar 1 framework, increasing the capital requirements against risks not adequately captured in the Basel II framework. Significant increases for trading book and securitization positions have already been introduced in Basel 2.5 proposals (July 2009). The Basel III proposals primarily modify the treatment of exposures to financial institutions and the counterparty risk on derivative exposures and will be effective from January 1, 2013.

### Description of the key changes

- Calibration of counterparty credit risk modelling approaches such as Internal Model Methods (IMM) to stressed periods
- Increased correlation for certain financial institutions in the IRB formula to reflect experience of the recent crisis, new capital charges for Credit Valuation Adjustments, and wrong-way risk
- "Carrot and stick" approach to encouraging use of central counterparties (CCPs) for standardized derivatives
- Improved counterparty risk management standards in the areas of collateral management and stress-testing

### Implications

- Still a degree of uncertainty over the final capital impact as Credit Valuation Adjustments charge is being revised to reflect significant industry criticism.
- Controls and quality of the CCPs' risk management is critical as risk is focused on central bodies.
- Reduce level of intra-financial sector business arising from increased capital charges intra-sector.
- Costs of dealing with financial counterparties need to be priced into the business, leading to a review of the business model.

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# Remaining questions

The G20 endorsement of the Basel III framework is by no means the end of the story. Many items and details within the proposals are not yet finalized and may not be for some time to come. These include:

- Identifying, defining, and treating "systemically important" firms (expected in 2011)
- Capital charge to deal with Credit Valuation Adjustments (CVAs)
- Agreeing a framework for forward-looking provisioning to limit the build-up in credit growth through under-pricing of future risk
- Eligibility of non-common equity Tier 1 and Tier 2 instruments
- Developing the counter-cyclical capital buffer concept for individual firms
- Revising the Net Stable Funding Ratio (NSFR) for long-term liquidity following significant criticism of its design and financial impact on institutional funding.

There are additional unresolved issues involving the interaction between Basel III and other regulatory reform proposals, including the Dodd-Frank Act and the Volcker rules.

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# Actions to consider

| Actions to consider in respect of capital management | |
|---|---|
| **Actions to consider in respect of capital management** | • Carry out appropriate scenario planning and impact assessments to ensure the development of a successful capital strategy<br>• Identify which businesses have most attractive fundamentals under Basel III and which businesses in the firm's portfolio should be considered for exiting, growing, or diverting<br>• Ensure managers have adequate incentive to optimize use of capital<br>• Apply consistent, quantified capital objectives throughout the group<br>• Identify the changes needed to fine-tune/lower capital consumption<br>• Ensure the firm is geared up to deliver measurement and management of capital position and requirements on a sufficiently timely basis<br>• Consider how to address the pricing implications arising from changes in the capital requirements for certain products<br>• Review whether the same business models can continue under a different structure, minimizing capital penalties (e.g., branch versus subsidiary)<br>• Prepare to be able to meet accelerated implementation time scales if required |
| **Actions to consider in respect of liquidity management** | • Ensure an understanding of current liquidity position in sufficient detail and possession of knowledge of where the stress points are<br>• Ensure management has adequate incentive to optimize use of capital<br>• Consider the impact of new liquidity rules on profitability and whether it has been factored into key business processes and pricing<br>• Check that liquidity planning, governance, and modeling are in line with leading industry practice<br>• Determine an appropriate series of liquidity stress tests and how these will change over time<br>• Gain awareness of the likely implementation timetable for different elements of the global and national frameworks being proposed<br>• Assess the firm's liquidity strategy in light of the existing legal and regulatory structure of the organization and identify whether the systems, data, and management reporting are adequate to meet the requirements |
| **Actions to consider in respect of general capital planning** | • Ensure that businesses are correctly charged for the capital costs of the business that they are doing<br>• Ensure that Basel III capital implications are taken into account for new business and consider how existing long-dated business can be revisited<br>• Examine how non-core businesses, insurance subsidiaries, and other financial institutions can be sold or restructured<br>• Consider the introduction of external capital into specialist structure models to mitigate the capital impacts arising<br>• Focus on Basel II implications as well as Basel III given that Basel III amplifies any increases in RWAs arising from Basel II<br>• Examine the performance of existing assessment methodologies (e.g., IRB models)<br>• Review existing data quality – Are the benefits from collateral information or improved re-rating of obligors due to inappropriate processes missing? |

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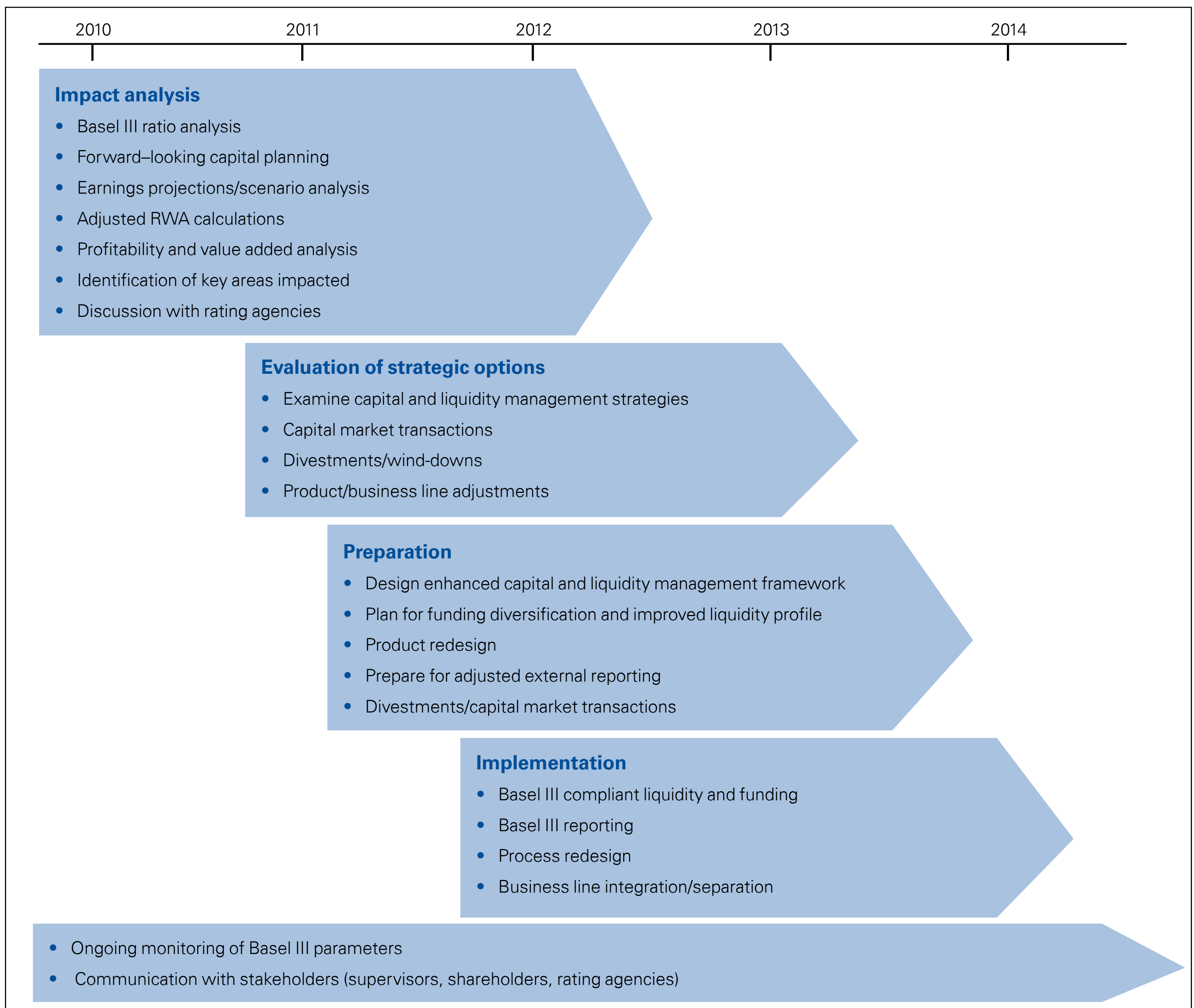
# What does the transformation roadmap look like?

Firms that wish to succeed in a post-Basel III environment should have started to consider the implications of Basel III already. The time line below shows a possible roadmap for consideration.

Despite a lack of absolute clarity, it would be prudent if an attempt is made as soon as possible to understand the impact of the framework. The Basel II experience proved that early impact analyses, evaluation of strategic options, and a robust planning and preparation phase are all crucial to success. Firms must remain flexible to adapt to subsequent changes and developments.

We illustrate below a range of recommended time lines for undertaking and evaluating each phase, depending on the current position of the firm.

## Possible phased Basel III implementation roadmap

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From KPMG's experience of delivering regulatory change programs, including Basel II implementation, a core program implementation team and the qualities of the Basel III programs director should include:

| Key project team | Key program director skills |
|---|---|
| • COO<br>• Finance function representative, including CFO<br>• Group risk, including CRO<br>• Regulatory risk/compliance<br>• Regulatory reporting<br>• Group legal<br>• Capital management<br>• IT<br>• Treasury<br>• Core impacted business functions | • Good understanding of bank's operations<br>• Strong links into risk, finance, and risk mitigation into areas such as product design, marketing, capital planning, and treasury<br>• Ability to coordinate multiple mini-project elements rather than the need to design and implement new core IT systems<br>• Understanding of broader regulatory framework<br>• Strong sponsorship from C-level suite to drive necessary changes |

# How KPMG can help

We have at our service some of the foremost and most experienced advisors in the area of risk, capital, and liquidity management. Our risk and compliance specialists bring with them diverse backgrounds in industry, regulatory, consultancy government, and academia. We have undertaken major engagements for financial sector clients of all sizes and varieties across a spectrum of risk-related issues, including:

- Impact analysis
- Model development and validation
- Capital and portfolio management
- Liquidity planning
- Governance, processes, and frameworks
- Valuations
- Stress-testing.

More widely, our corporate finance and transaction services specialists support clients in capital raising and divestiture of non-core businesses and portfolios, while our accounting advisory and restructuring teams help them deal with complex legal entity rationalization and approaches towards provisioning.

Our integrated approach is aimed at providing a tailored, multidimensional service for our clients that meets their specific needs.

In general, KPMG's role as a facilitator in the implementation of the Basel III framework could include (but is not restricted to):

- **Documentation, including policies and procedures**
- **Migration management**
  - Incremental changes for additional regulatory requirements
  - Gap analysis
- **Capital attribution**
  - Attribution of risk capital to business units and risk centers
  - Determining trading diversification benefits
- **Capital calculations**
  - Market and credit risk capital for both Basel II and Basel III
- **Model validation**
  - Validation of clients' internal models for market risk
  - Testing inputs, theory, backtesting, testing of hypothetical portfolios
- **Data aggregation**
  - Incorporating relevant information from various systems into proper formats
  - Migration from manual Excel® format to more reliable systems

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# Conclusion

The Basel III framework introduces a paradigm shift in capital and liquidity standards, which was constructed and agreed to in relatively record time. Many elements, however, remain unfinished, and even the final implementation date looks a long way off. However, market pressure and competitor pressure is already driving considerable change at a range of organizations. Firms should ensure they are engaging with Basel III as soon as possible to position themselves competitively in the new post-crisis financial risk and regulatory landscape.

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