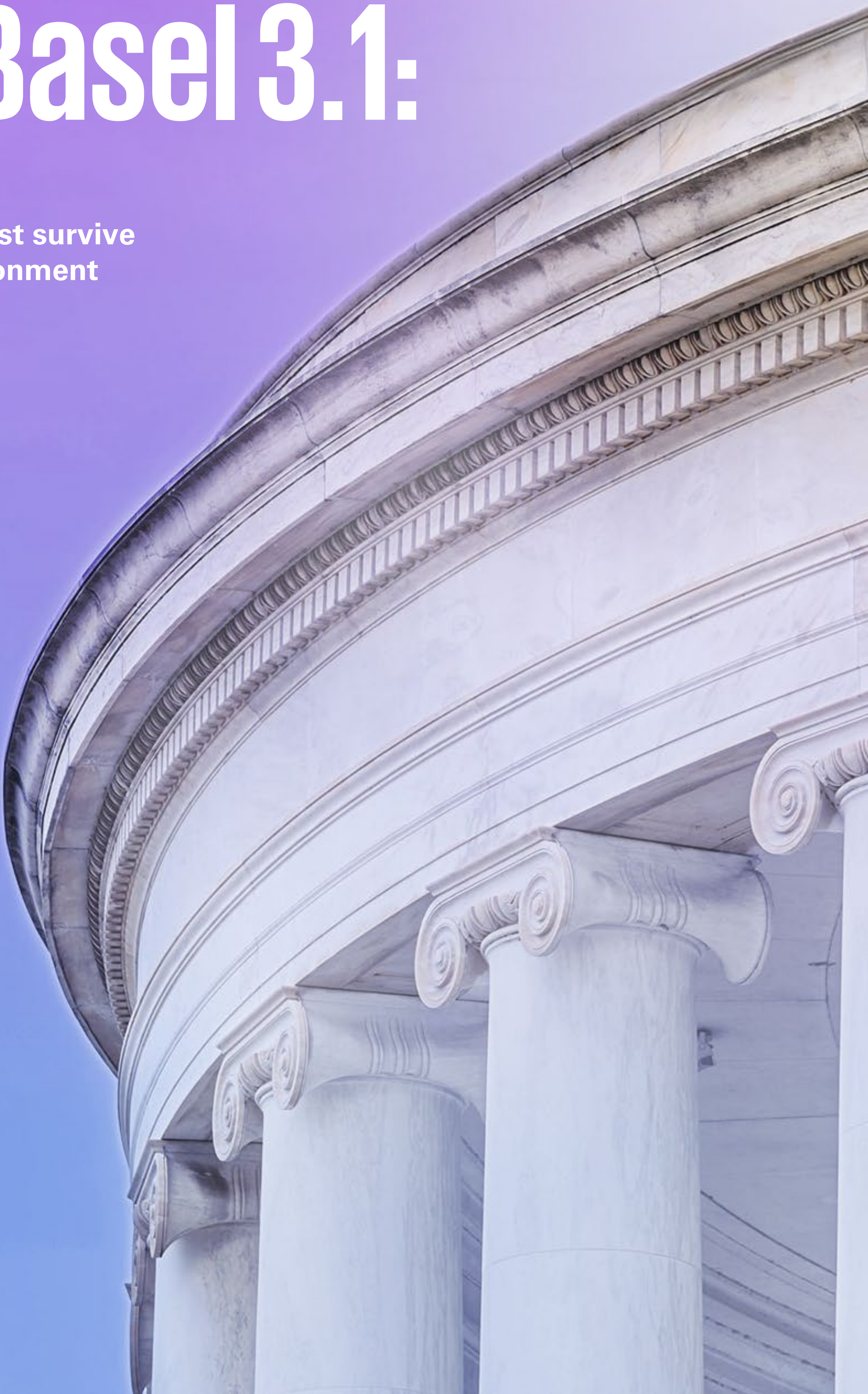
Optimising returns under Basel 3.1:

How to thrive and not just survive in a post-Basel 3.1 environment



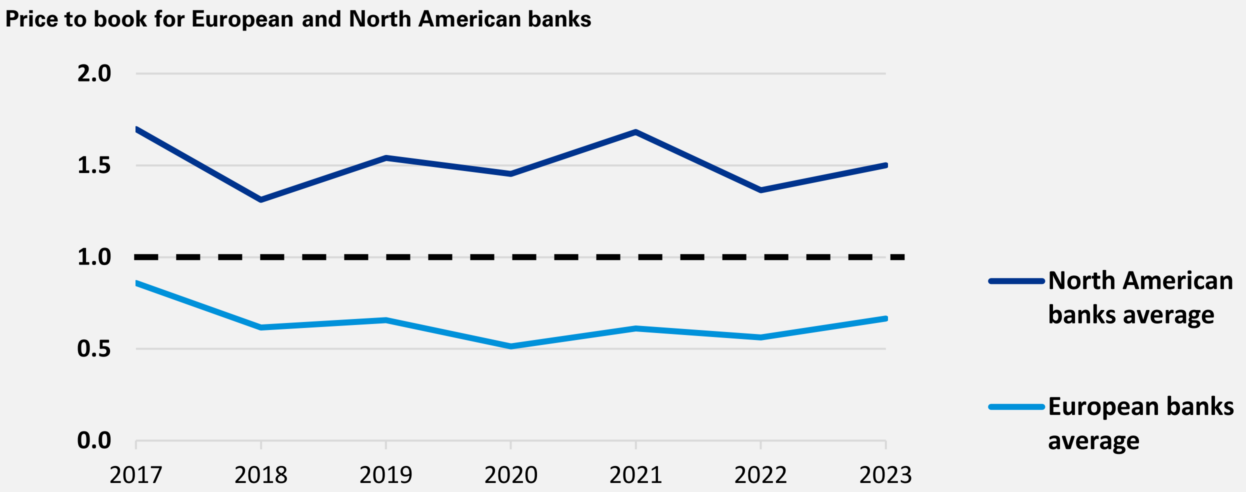
Introduction

One of the most pressing problems for the banking sector, and indeed for the wider global economy as a whole, is how to solve 'the returns dilemma'. For far too long, bank returns, particularly in the UK and Europe, have been far too low – eroding stakeholder confidence and shareholder value (see figure 1 below).

The causes of this are many and varied but one of the key contributors to this overall outlook must be the significant and seismic changes in bank capital and funding requirements over the last decade from Basel 3. And of course, banks are now facing into the next stage of this journey with Basel 3.1 – a set of reforms which will again reshape the banking landscape and will exacerbate the 'returns dilemma'.

So what is Basel 3.1 and, more importantly, what can banks do about it?

Figure 1: Bank P/B ratios at Dec 23



What is Basel 3.1?

Basel 3.1 (also known as "Basel III: Finalising post-crisis reforms", "Basel III Endgame" and "Basel IV") is the latest in a series of banking reforms developed in response to the 2008/2009 financial crisis.

Whilst the EU authorities propose an implementation date of 1 January 2025[1] , the UK and US banking regulatory agencies propose a 6-month delayed start date to 1 July 2025[2,3]. Although the specific implementation rules and timeframes vary across jurisdictions, the package covers almost all elements of bank capital requirements – with changes to credit risk, market risk, operational risk and credit valuation adjustment risk all included.

Whilst some elements of the package (most notably the output floor, on which more below) have a five-year transitional period to achieve full compliance, many other elements of the framework will be implemented fully from day one.

The Output Floor

By far and away the biggest change from Basel 3.1 relates to the implementation of the Output Floor which is expected to have the biggest impact on capital requirements by capping the benefit that can be obtained from internal models. Under these proposals, banks using the Internal Ratings Based ("IRB") approach will have a new minimum threshold to pass, with capital levels 'floored' based on a minimum percentage of the less risk sensitive standardised approaches ("SA"). Based on an EBA study published on September 2023 covering 157 banks, the total tier 1 minimum required capital will increase by 16.3% with the output floor being the most significant driver of the increase (+6.8% of the aggregate increase is attributed to the output floor)[4] .

But, the risk weighted asset ("RWA") inflation arising from the output floor is only half the story. The output floor is also going to change radically and fundamentally the way banks manage capital. In our view, banks will be incentivised to manage their capital at an 'efficient frontier' around the floor level as shown in the Figure 2.

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[1] *See European Central Bank "Basel III finalisation in the EU: the key elements and how they make the EU banking system more resilient"*

[2] *See Bank of England (2023), "Timings of Basel 3.1 implementation in the UK", press release, 27 September.*

[3] *See "Agencies request comment on proposed rules to strengthen capital requirements for large banks", joint press release, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, 27 July 2023.*

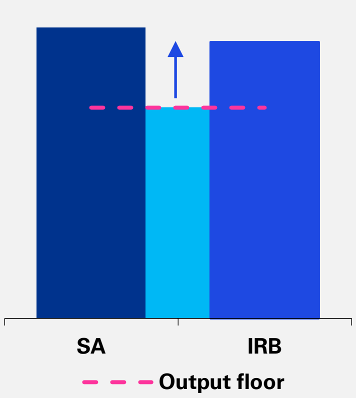
[4] *See European Banking Authority - Basel III monitoring exercise results based on data as of 31 December 2022*

Figure 2: Output Floor 'efficient frontier'

Implication of being away from the floor…

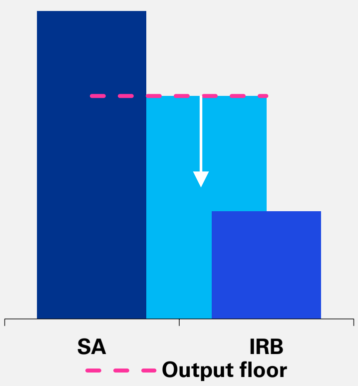
Assuming that internal models more accurately reflect the risk of exposures than standardised approaches, there are implications of being far below or above the output floor…

Far above the floor



- Inefficient as this incurs the cost of models but the bank would not be sufficiently compensated by reductions in capital requirements.
- In addition, this would mean the bank's portfolio is not skewed to assets where IRB gives a competitive advantage.

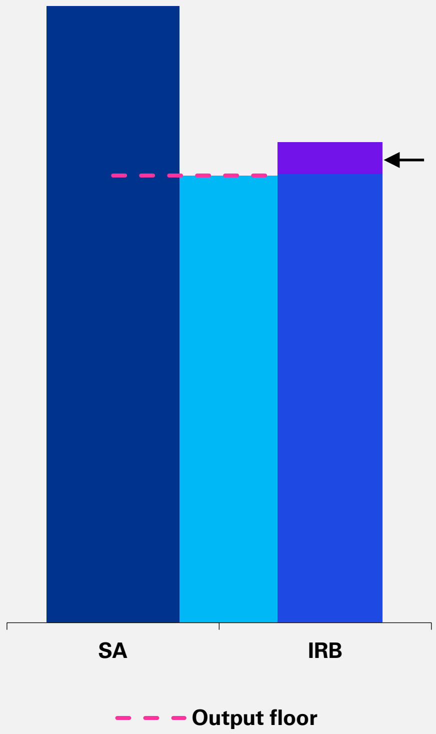
Far below the floor



- Inefficient as this requires holding capital that is not reflective of the risk.
- If the additional capital is priced in, the bank risks becoming uncompetitive versus peers who are managing the portfolio at or around output floor level.

Optimal management of the floor…

As a results of these implications, firms should typically look to manage resources close to the floor as follows depending upon their capabilities:

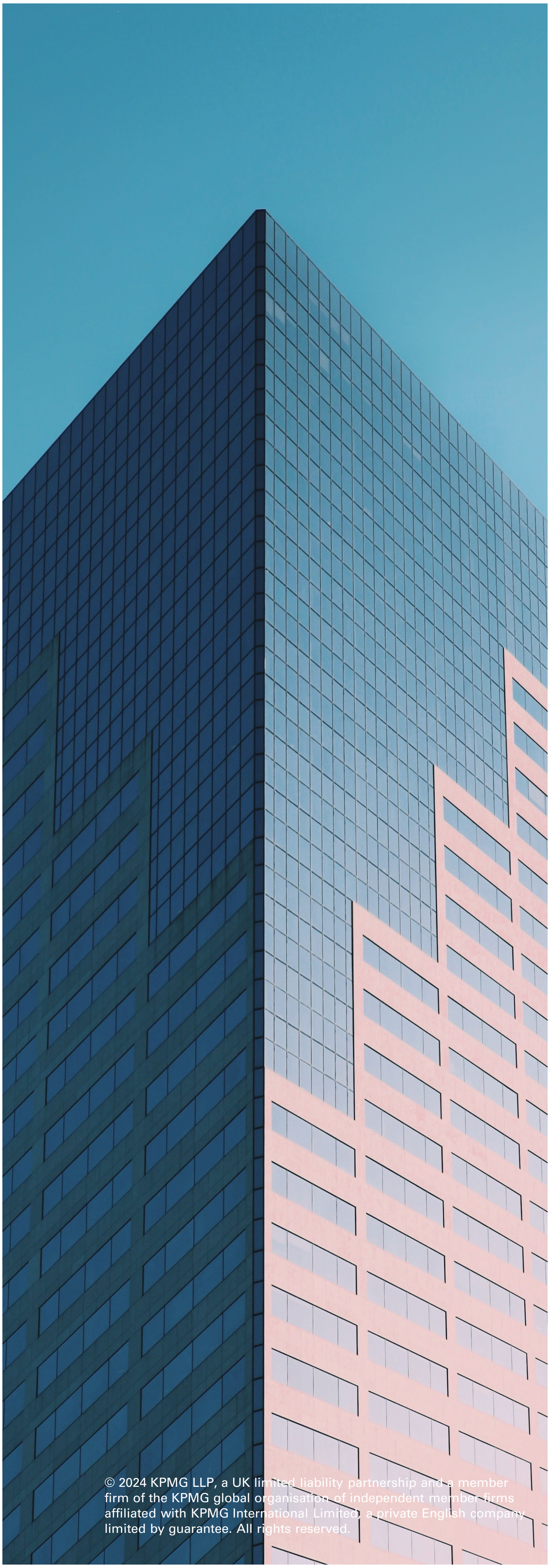


Efficient frontier is to manage portfolio at, or slightly above, the 72.5% of standardised RWAs floor level.

Because the 'floor' applies at an overall portfolio level, in order to be on this 'efficient frontier' banks will need to manage capital at the portfolio level (the 'portfolio effect').

This is fundamentally different from the 'loan-by-loan' or 'asset-by-asset' approach banks have historically taken under Basel 3[1]. Managing the portfolio effect efficiently will lead to significant changes not only operationally, in terms of the mechanisms and processes for calculating capital requirements and moving capital around within the business, but also culturally, in the way capital is perceived and understood within the business.

[1]*However, it should be noted that, for economic risk a portfolio effect has always been consider for capital purposes e.g., concentration risk.*



In our view, therefore, if banks are going to solve and resolve the 'returns dilemma' post Basel 3.1 they will need a different playbook.

Historic technical disciplines around model optimisation and risk methodologies will still retain a role in improving returns on capital, as will those organisational disciplines such as legal entity delivery and booking model optimisation. However, they are also subject to the law of diminishing returns. Successful balance sheet optimisation under Basel 3.1, and the Output Floor, will depend on banks' abilities to make strategic and structural changes to manage their balance sheet more centrally and dynamically to solve for the portfolio effect. For example, we expect the reduced flexibility of 'monoline' banks to respond to the Output Floor to impact the competitive dynamics of the banking industry. As these banks typically focus on providing a specific type of credit, it is more difficult for them to pivot away from those exposures if they are more capital intensive under the Basel 3.1 reforms.

Significant operational and cultural changes take time to develop and embed. It is therefore critical that capital management and optimisation are embedded in banks' Basel 3.1 programs. Too often, too easily and totally understandably – the focus of time, attention and budget from these projects is on operational compliance and not strategic management. This is not just a lost opportunity, it's a foregone imperative. If banks want to thrive and not just survive post Basel 3.1 they must incorporate this as an integral part of their Basel 3.1 programs.

Based on KPMG's experience and deep expertise in the banking sector, we have identified three key and practical areas where we think banks need to focus, and invest in, to achieve this strategic change:

Embed capital-sensitive performance measures;

Accelerate balance sheet velocity; and

Centralise control of financial resource management and allocation.

These ideas are not new. Many banks will have tried to integrate one or more of them in their businesses in the past. But, in a Basel 3.1 world, these imperatives are no longer 'nice to haves' that can be dipped in and out of when time and resources allow - they are an essential foundation for long-term success. They all need to be embedded into the operating model and integrated into every level of decision-making, as we explain over the next few pages.

Embed capital-sensitive performance measures

The first and most fundamental step banks need to take is to drive performance measures into the business that are sensitive to capital intensity. Ideally these should directly align with the performance measures that banks are held to by shareholders – e.g. return on tangible equity ("ROTE").

Too often business performance and capital allocation decisions are based on measures that approximate to, but do not exactly reflect, the ultimate performance measure that banks are required to deliver – whether this is net interest margin ("NIM"), return on RWA ("RoRWA") or other metrics.

There are good reasons for this, of course, and there are various methodological complexities with embedding ROTE as a performance measure. Whereas there are simplicities in use, and understanding associated with, other measures (particularly NIM) not least because of their long-standing use.

However, performance measures drive behaviours and ultimately drive outcomes, and in a Basel 3.1 world we see the use of measures such as NIM as increasingly problematic. This is because NIM emphasises maximising interest income generated from loans and investments which in turn results in an 'originate and hold' behaviour.

'Originate and hold', however, has a number of drawbacks. Firstly, in the short-to-medium term, it is not (or not necessarily) the right strategy in a period of regulatory change where the capital requirements for portfolios will change and therefore banks will need to consider divesting, exiting or reducing exposure to certain portfolios. Secondly, once Basel 3.1 is implemented, 'originate and hold' is largely incompatible with the type of agile portfolio management we see as being required to respond to the Output Floor.

In comparison, embedding a ROTE measure has significant advantages. Not only does it directly align business incentives to bank performance, it also takes a broader and more holistic view of returns and how these are generated (including fee and origination income). This in turn fundamentally enables a variety of risk distribution strategies and increases balance sheet velocity – which is our second key recommendation.

Accelerate balance sheet velocity

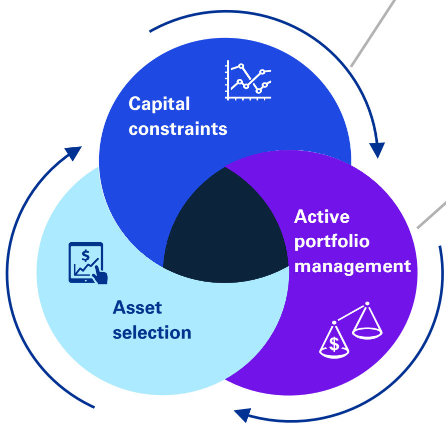
Whilst a number of factors are driving banks to increase the velocity of their balance sheet, we note that Basel 3.1 has three impacts:

Balance sheet velocity

Balance sheet velocity refers to the speed at which banks can re allocate financial resources across business lines, or within a business line, to ensure they are deployed in the most efficient way.

Capital constraints

It is expected to increase overall capital constraints, reducing balance sheet capacity and therefore increasing the potential attractiveness of 'recycling' resources to boost returns.



Asset selection

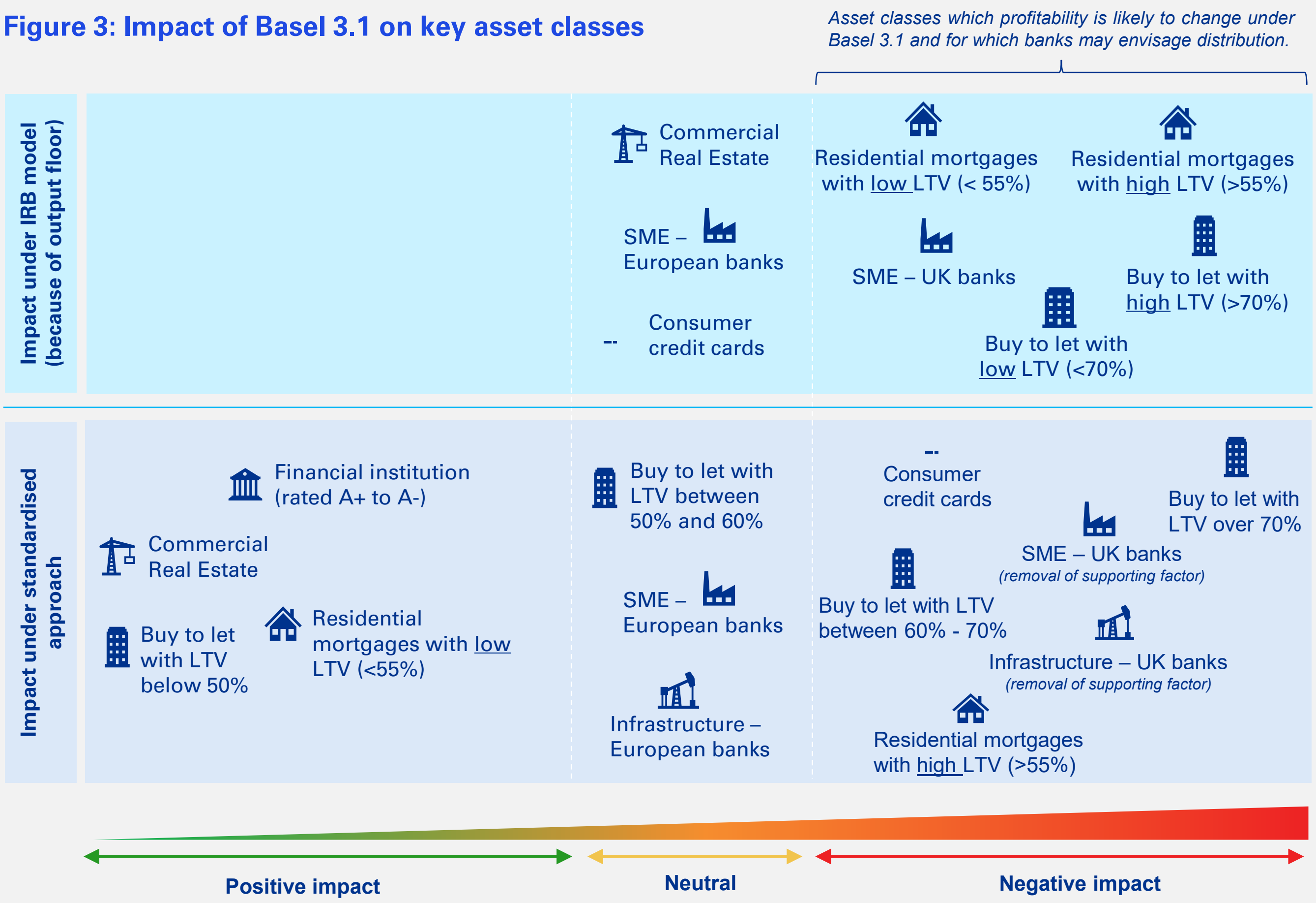
The Output Floor is likely to change the type of assets securitised and distributed. In part this is because of the shift in risk weights (see figure 3 below) but it is also a result of the Output Floor effect incentivising distribution of assets with a higher differential between the standardised risk weight and IRB risk weight.

Active portfolio management

The Output Floor will entail active portfolio management – whereby banks will be required to rebalance portfolio make-up composition and RWA profile to remain on the 'efficient frontier' – driving increased velocity.

Figure 3 illustrates, at a high-level, the main asset classes which we believe will be impacted by Basel 3.1 implementation (either as a result of an increase of the risk weight under the standardised approaches, or as a result of the Output Floor impact on assets with the highest differential between the standardised approach and IRB risk weights). The figure also highlights the asymmetry in the treatment of some assets between the EU and the UK which will impact the competitiveness of UK banks.

Figure 3: Impact of Basel 3.1 on key asset classes



Banks need to understand these dynamics and drive an appropriate cultural shift in the way they manage their balance sheet, to favour alternative 'originate to distribute' ("OTD") models that act as 'business multipliers', increasing returns (as measured by ROTE) for the same capital utilisation.

Whilst OTD models have been blamed for contributing to the financial crisis, today regulators have introduced additional controls to reduce risk of moral hazard (including minimum risk retention for Significant Risk Transfer, additional disclosure requirements for securitisation etc.).

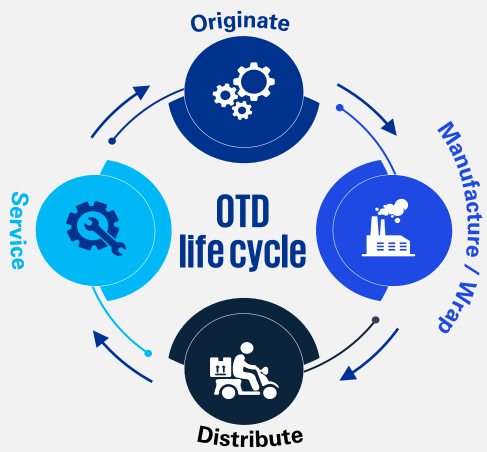
In essence, Basel 3.1 means the revenue model needs to change to one that is much more fee-based, driving ROTE, and much less about the net income spread. In this model, banks are effectively recycling capital by looking at the portfolio as a whole, slicing it and segmenting it and then moving risk-sensitive assets on, either internally within the group or externally to yield-searching firms, such as insurers, assets managements or pension funds.

Figure 5 outlines a number of different mechanisms that can be used to move assets around internally and externally, each with their own advantages and disadvantages.

Figure 5: Tools to recycle financial resources and earn additional fee income

Distribution formats

- Sale / syndication / repack
- Securitisation (cash / synthetic)
- Forward Flow
- Focus on capital relief: credit linked note / credit default swap
- Focus on funding: secured loans / covered bonds
- Insurance / financial guarantee (funded / unfunded)



Distribution toolkit

- Syndication
- Sub-participation
- Strategic partnerships
- Fund
- JV
- Side car
- Platform

External distribution

Externally, securitisations, especially significant risk transfer (SRT) securitisations, are one of the key tools at the disposal of banks to distribute risk and optimise their balance sheets. This is a market that has been increasingly popular in Europe over the past few years and is beginning to grow in other jurisdictions such as Canada, US, Hong Kong and Japan. Regulators are increasingly encouraging SRT via Simple and Transparent Standardised ("STS") transactions (Europe), recalibration of P factor i.e. non-neutrality adjustment (Europe and UK) and clarifying reg Q (US). Having such tools will become essential for efficient management of capital, especially as the prevalence of 'originate to distribute' business models increases over the traditional 'originate to hold' models. For further information on Securitisation in Balance Sheet Optimisation, see our detailed report.

Internal distribution

Alternatively, banks can also look internally to distribute assets and the associated risk effectively. Banking groups with several legal entities, and diverse business models, should maintain a focus on opportunities to distribute risk internally (e.g. to captive insurers / asset managers or to entities with trapped capital / funding) to optimise returns and internalise value as much as possible.

There are multiple reasons why it might be more attractive to have assets located in one part of a banking group than another part. It could be as simple as opportunities arising from differing regulatory regimes in different parts of the world. It could be to do with where certain specific funding sources are located in the bank. Or with the various business sectors that a single banking group operates in. For example, it is often more beneficial within the same organisation to hold an infrastructure asset in a life insurer versus an infrastructure asset in the bank, as the return on equity for that asset (if structured appropriately) will be greater in the insurance company than in the bank. This is because the insurance regulatory capital regime includes benefits for close duration matching of assets and liabilities and, as a long dated asset class, Infrastructure matches well with longer dated life insurance liabilities.

Whichever mechanisms are used, the underlying principle is the same: to manage ROTE effectively, look at the different features of the different balance sheets within the bank and work out which assets and which pots of funding should sit where. This will be most effective where the bank has processes to review allocations on an ongoing basis and act accordingly.

Of course to make these decisions – what should be distributed, to where and how – and to make these decisions on a regular basis, as necessitated by the Output Floor, requires a more centralised co-ordination, or even control, of financial resources than exists in many banks today. Therefore, embedding and sustaining balance sheet velocity requires banks to focus on our third recommendation 'centralised control of financial resource management and allocation'.

Centralise control of financial resource management and allocation

In our view, the implementation of the capital Output Floor under Basel 3.1 requires banks to make financial resource management decisions more centrally. Banks therefore need to consider whether their current organisational design facilitates the transparency and ways of working to optimise this picture.

Every bank has a different organisational model and is structured differently. One of the most common structures is a federated, decentralised model, in which different parts of the bank are responsible for managing their own financial resources. This model will be substantially harder to sustain in a post-Basel 3.1 environment given the need to view returns at a portfolio level (rather than loan-by-loan) and the substantial inefficiencies it creates in a business model already challenged by returns.

In our view, adopting a centralised model instead allows banks to allocate capital more easily to higher return businesses and recycle capital and funding to facilitate this.

However, it is not only a question of implementing the structures and processes to enable this to occur. For most banks, it will also require a considerable change in culture. Business units will often be accustomed to managing their own pots of capital and funding and deploying as they see fit during the year.

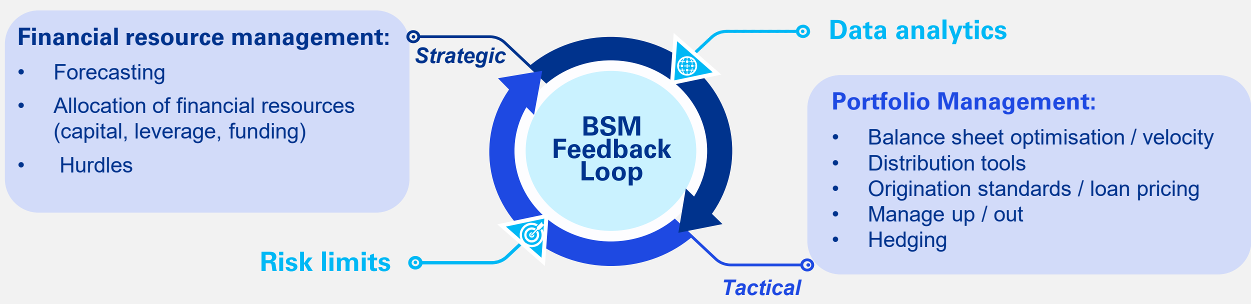
In our view, Basel 3.1 will drive banks to a construct where these decisions are influenced and directed much more actively by a central decision-making unit. If it's felt that capital and funding is not being used as effectively as it could be, it will be redeployed elsewhere. In essence, individual commercial business units will no longer 'own' their balance sheet.

Instead, the balance sheet will be owned by Treasury (the central financial resource management and portfolio management function – see Figure 6 below). It is they who will ultimately make decisions around capital allocation and how best to use the balance sheet to achieve the optimal ROTE outcome.

From here, Treasury can create an internal marketplace for capital and funding within the business, with different business units bidding for resources to deploy.

An organisational shift is required to support this new way of working, and first line staff need to be incentivised to behave accordingly. It also requires better 'real time' data to measure and monitor key metrics, as well as the operational mechanisms, through forecasting, positioning and integrated feedback loops, to make these decisions centrally. All these elements need to be brought together seamlessly to support the new operating model - a transformational change that is likely to be evolutionary, rather than revolutionary.

Figure 6: Balance Sheet Management ("BSM") feedback loop



Central control and ownership of the balance sheet with greater influence on business strategy.

Manage up, manage out with accountability for setting, monitoring and enforcing hurdle rates.

Dynamic, forward looking allocation of resources to increase balance sheet velocity and ROTE.

Responsibility for monitoring both distribution and origination, which allows pricing and incentives to be adjusted dynamically.

The idea is that a centralised model:

- **Enables greater agility to react in real time to divergence from expectations, both external e.g. changing market dynamics and internal e.g. performance against plan;**
- **Injects more tension for the businesses and increases commitment and accountability, as businesses are incentivised both positively and negatively to deliver on what they say they will do;**
- **Creates a marketplace where if one business is underachieving, capital and funding can be redeployed to businesses that are performing better;**
- **Allows on going visibility of business unit performance and capital allocation, based on more frequent forecasting, performance analysis and stress testing, rather than an annual review that comes too late to take any corrective action.**

What next?

There is considerable divergence among banks in their readiness for Basel 3.1 and in their preparations for how capital management models need to change. Not only for Basel 3.1 compliance, but for long-term success.

Although Basel 3.1 itself has been subject to delays, the time for action is now (for more detail please see our other reports on Basel 3.1). The changes and approaches outlined above are not short-term fixes and should be considered as an integral part of the Basel 3.1 programme. Many will require months or years to implement fully.

With turbulent times ahead, banks must start that journey now to be in the best possible position to thrive in the new environment.

To recap…

- **The Output Floor will not only result in RWA inflation, but is also going to change radically and fundamentally the way banks manage capital.**
- **In response, the first and most fundamental step is to drive capital sensitive performance measures into the business, ideally ROTE.**
- **This in turn enables a variety of risk distribution strategies in order to accelerate balance sheet velocity, so that the bank can effectively recycle capital, move on risk sensitive assets and maximise returns.**
- **To make such decisions on a regular basis what should be distributed, to where and how requires centralised ownership of the balance sheet, and control of financial resource allocation, by Treasury (in particular, the central financial resource management and portfolio management function)**

How can KPMG help?

KPMG is supporting some of the largest global banks to comply with Basel 3.1, and to optimise their balance sheets. We have set out below just a few ways in which we can support you:

Design project plan and road map

- Design the North Star target operating model (TOM) for financial resource and portfolio management based on Basel 3.1 impact and strategy including organisational design, forecasting, data and models and incentivisation.
- Perform a gap analysis against this North Star.
- Develop a costed plan for delivery (including quick wins, benefits and long term objectives).

Develop capital forecasting and allocation capabilities

- Identify strengths and development areas in current systems and capabilities (e.g. data availability/quality, technology solutions, scenario analysis etc.).
- Plan and support in development of forecasting and allocation capabilities.

Develop organisational structure and operating model

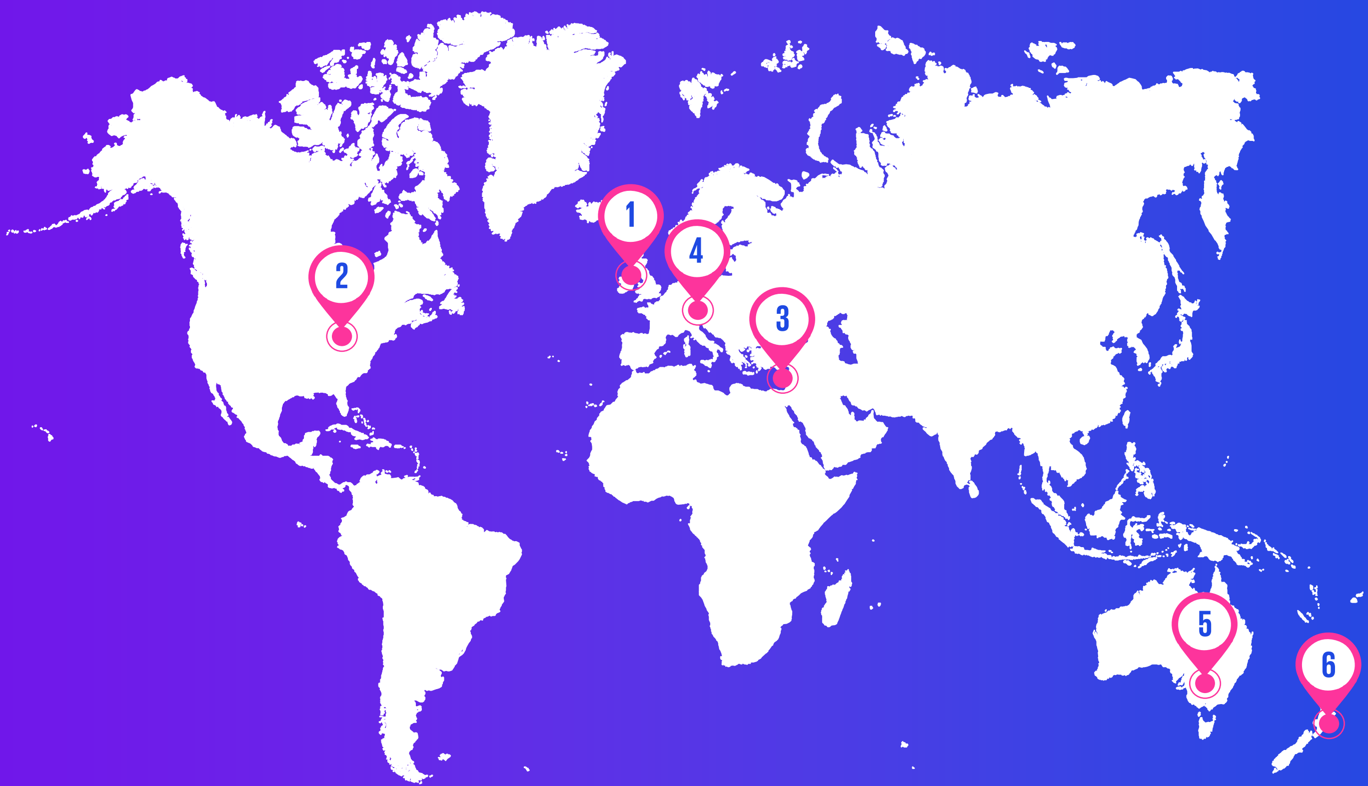
- Re design organisational structure.
- Design and implementation support for financial resource and portfolio management TOM.
- Tactical support as you ramp up financial resource and portfolio management.

Develop originate to distribute capabilities and tooling

- Plan and support in development of tooling (e.g. internal / external securitisation, credit default swap, Repo, total return swap, non payment insurance etc.).
- Design and implementation support for an originate to distribute model.

If you would like to discuss the changing regulatory or economic environment and what it means for your bank's management of financial resources, please don't hesitate to get in touch with our global team (see next page for key contacts)

Get in touch with us



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