KPMG

Basel 4 publications

A comparison of the Basel Committee and US Notice of Proposed Rulemaking (US NPR) for Basel III Endgame

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October 2023

US NPR – Overview

In July 2023, the US Federal Reserve Board (FRB), the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) jointly published a Notice of Proposed Rulemaking (US NPR), referred to as Basel III Endgame. The proposals in the NPR aim to implement the final components of the Basel capital reforms, often referred to as Basel 4. There are several elements within the proposals that would have significant implications for both US banks and non-US banks operating in the US.

The key changes and impacts resulting from the US NPR are:

Scope of application

- The NPR would apply to banking organisations (and their subsidiary depository institutions) with:
  - Total assets of $100 billion or more
  - “Significant trading activities”, based on $5 billion of trading assets plus trading liabilities (calculated on four-quarter averages)

Market risk

- Provides for enhanced “risk-sensitivity” by introducing the concept of a trading desk under the models-based measure for market risk
- Two new calculation approaches: standardised approach (SA) and internal model approach (IMA)
- Three primary components of SA: sensitivities-based method (SBM) capital requirement, standardised default risk capital (DRC) requirement and residual risk (RRAO) capital requirement
- Two primary components of IMA: expected shortfall (ES) for modellable risk factors and stressed expected shortfall for non-modellable risk factors (NMRF)

Credit risk

- Expanded risk-based approach (ERBA) to replace advanced internal model-based approaches
- Application of standardised approach for counterparty credit risk to banking organisations subject to Category III and IV standards
- New definitions for defaulted exposures and defaulted real estate exposures

Operational risk

- Replacement of internal model approach with a standardised approach derived from an organisation’s “business indicator component” and “internal loss multiplier”

Credit valuation adjustment (CVA)

- Removal of models-based approach for CVA capital requirement calculation
- Introduction of two new methodologies for calculating CVA capital requirements: the basic approach (BA-CVA) and the standardised approach (SA-CVA)

Reporting

- Floor to limit the use of IMA to decrease capital requirements for market risk - calibrated to 72.5% of RWAs under SA approach
- Three-year transition period for expanded total risk-weighted assets (RWAs) - from 1 July 2025 to 1 July 2028.

	1 Jul 25 – 30 Jun 26	1 Jul 26 – 30 Jun 27	1 Jul 27 – 30 Jun 28	1 Jul 28 onwards
Percentage of expanded total risk-weighted assets	**80%**	**85%**	**90%**	**100%**

Overall the FRB estimates that, by implementing the final reforms as proposed, RWAs would increase by 20% in aggregate compared to current requirements – market risk accounts for approximately 70% of the increase.

BCBS vs US NPR – FRTB rule change analysis

KPMG professionals have performed a detailed comparison of FRTB SA, IMA and qualitative and reporting requirements to provide (a) a line by line comparison of the requirements and (b) an assessment of the impact of the changes.

The BCBS requirements were used as a basis of comparison against the US NPR proposal. We have used the BCBS hierarchy as the global basis for comparison. Figures 1.1, 1.2 and 1.3 reflect the comparison between BCBS and NPR regulations for SA, IMA, and qualitative and reporting requirements respectively.

Please refer to subsequent pages for a summary of changes, and reach out to your local KPMG firm contacts for a detailed view of the broad-ranging analysis performed.

The categorisation of each FRTB requirement is summarised below:

- **Change -** if the requirement has remained the same between both regulations, it is flagged as "No change“. If not, it is flagged as “Change“.
- **Not applicable -** as US NPR requires banks to capitalise DRC using SA irrespective of its IMA eligibility, sections related to IMA DRC are flagged as “Not applicable”.
- **Not changed but more prescriptive -** where the BCBS and NPR requirements align with one being more prescriptive than the other, the requirement is flagged as “Not changed but more prescriptive”.
- **Impact -** where requirements are categorised as “Change”, if they are expected to have a material impact on the capital charge or to be operationally burdensome, they are flagged as “Material”. If not, they are flagged as “Immaterial”.
  - **Immaterial change -** driven predominantly by wording or reference change
  - **Material change -** driven by a requirement that has been removed, modified or added

Breakdown of the rules based on the categorisation highlighted above:

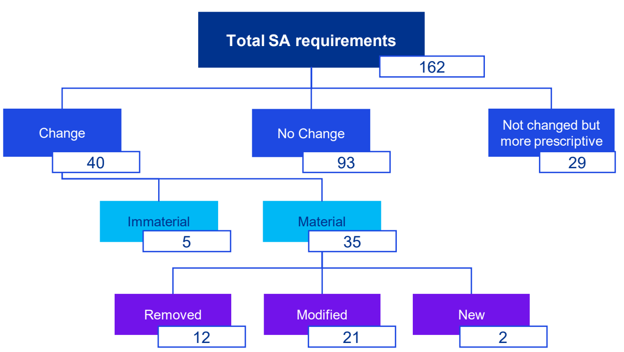

Figure 1.1: SA requirements

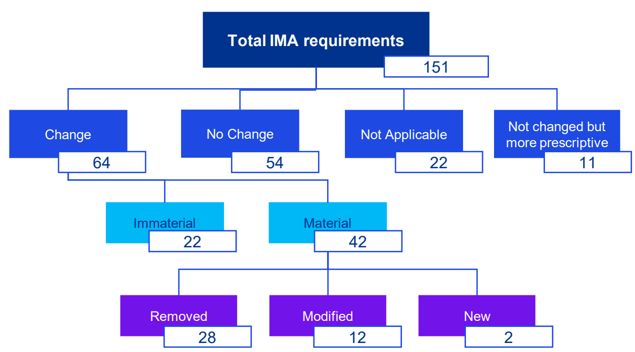

Figure 1.2: IMA requirements

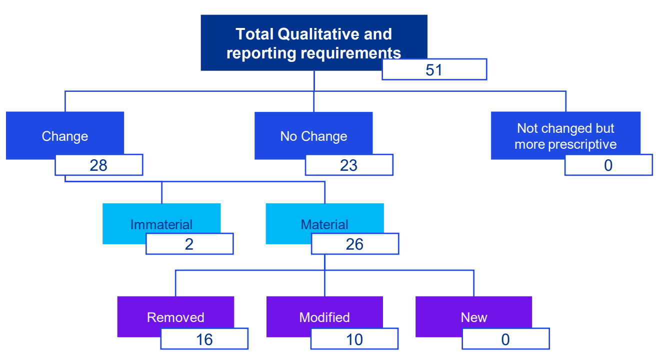

Figure 1.3: Qualitative and reporting requirements

BCBS vs US NPR – Summary

Market risk - overview

The US NPR for market risk capital calculation puts forward some significant changes to SA, IMA and other qualitative requirements. Though the final regulation may be modified based on feedback to the consultation, the draft proposal has already created a ripple effect, with other major jurisdictions updating, or considering updating, their own implementation timelines in response. On 27 September 2023, the PRA amended its implementation start date from 1 January 2025 to 1 July 2025.

The scope of the US NPR limits eligibility to use the SA and IMA for banks with:

a) average aggregate trading assets and trading liabilities, excluding customer and proprietary broker-dealer reserve bank accounts, over the previous four calendar quarters equal to $5 billion or more; or

b) 10 percent or more of total consolidated assets at quarter end as reported on the most recent quarterly regulatory report.

Speed-up nomination of trading desks

US NPR modifies the requirement around nomination of trading desks for IMA approval. Compared to the BCBS standards, which set a stringent IMA eligibility requirement to pass the back-testing and PLAT metrics over a period of 250 days, US NPR gives banks flexibility to get IMA approval for trading desks using a minimum of six months of back-testing and PLAT results. However, banks must demonstrate to supervisors that the positions for the trading desk applying for IMA are similar to those of another trading desk which has been IMA approved and should be categorised under amber zone which is subject to PLA capital add-on.

For IMA approval, BCBS requires nominated trading desks to contribute at least 10% of the aggregate market risk capital. Nomination of trading desks will become easier under US NPR, as it doesn’t specify this requirement.

Eliminate IMA DRC

Global banks are facing significant challenges to meet the requirements for IMA DRC and the subsequent IMA approval of trading desks. While many global banks are opting not to pursue IMA approval due to the DRC component, US NPR proposes to calculate DRC capital using SA DRC for all desks regardless of their IMA eligibility. This would mean higher capital requirements for those banks opting to use IMA under the US NPR approach.

Impact on capital

US NPR adds certain quantitative measures that would result in an increase in the market risk capital charge. These include:

a) introduction of fallback capital add-on requirement when aggregating total market risk capital, penalising exposures for which banks are unable to calculate capital using SA and IMA;

b) increase in risk weights (SA) and liquidity horizons (IMA) of RUB exposures under FX risk; and

c) increase in risk weights of exposures related to sovereign and MDBs sectors subject to credit spread risk.

US NPR also adds measures that would reduce the market risk capital charge. These include:

a) removal of the option to consider a shorter observation period (not less than six months) for ES capital calculation if, in the supervisor’s judgement, this shortened observation period is justified by a significant upsurge in price volatility; and

b) decrease in risk weights of electricity-related commodities under commodity risk.

BCBS vs US NPR – Summary (cont'd)

Impact on operational complexity

US NPR acknowledges the operational burden faced by banks while excluding NMRFs from Expected ES-based internal models and performing entity-wide back-testing. Hence, with supervisory approval, banks would be permitted to include NMRFs in their ES-based internal models, though such positions would still be required to be included in the Stressed Expected Shortfall (SES) measure for non-modellable risk factors. This modification will help banks to reduce their operational burden but will lead to a higher capital charge due to double counting of NMRFs (i.e. ES capital and SES capital).

The treatment of listed and well-diversified indices under the SA is another major change. Unlike the BCBS standards, US NPR does not highlight the conditions required to opt out of applying the look-through approach (LTA) for such instruments. This gives flexibility for US banks to exclude positions from applying LTA, one of the major challenges faced by banks globally.

On the other hand, there are certain requirements under US NPR which would be more operationally burdensome. For risk factors that pass RFET, banks would be required to update the input data for ES-based models on at least a weekly basis, compared to BCBS's recommended monthly frequency, resulting in stringent data management requirements.

Impact on governance and reporting

Certain more prescriptive BCBS governance and reporting requirements are missing in US NPR for market risk capital calculation:

a) Trading desk structure requirements:
   - number of head traders and their roles and responsibilities
   - scope and objective of a trading desk
   - clear reporting line to bank senior management
   - formal compensation policy linking the pre-established objectives

b) Reporting requirements: evaluation of inventory ageing reports and reports on the assessment of market liquidity for all the trading desks

c) Review and control requirements:
   - roles and responsibilities of independent risk control unit
   - daily reports prepared by independent risk control unit and reviewed by a level of management with sufficient seniority

Conclusion

US NPR has triggered debate at a global level, with banks assessing its potential impacts on capital charges, operational burden and governance. While certain US NPR requirements might lead to higher market risk capital requirements for US banks compared to their global counterparts, the reduction in operational and governance burden could encourage banks to opt for IMA.

The regulators have tailored the proposals to the requirements and functionality of the US market, however banks with global operations (either US headquartered banks with operations outside the US or non-US banks with operations in the US) will need to assess the impact of cross-jurisdictional capital arbitrage being created due to non-alignment of regulations and increasing cost of capital charges. US NPR raises many questions for industry stakeholders and it will be interesting to follow their responses and the regulators' feedback.

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