Is Basel III turning four?

How will the reforms to Basel III affect banks in the UAE?

Steve Punch looks at the implications for risk capital calculation.

The Basel III framework is a central element of the response of the Basel Committee on Banking Supervision to the global financial crisis. Released in June 2011, the original Basel III reforms were primarily aimed at strengthening the capital base of banks and introduced two new liquidity metrics: the Liquidity Coverage Ratio and the Net Stable Funding Ratio.

Since then, the Basel Committee has been busy drafting numerous new standards, including redefining requirements for credit, market and operational risks. These are expected to provide greater risk sensitivity when it comes to how banks are required to manage risk, especially credit risk. The aim is to allow the banking system to support the ‘real economy’ through the economic cycle.

Some industry leaders, including KPMG, have termed these fresh requirements as ‘Basel IV’. The Committee, however, views these as the final touches to the 2011 edition of Basel III, and not the implementation of a new ‘Basel IV’ framework.

The new standards are expected to impact the risk-weighted assets (RWAs), and off-balance-sheet exposures weighted according to risk, for all banks. RWAs are an estimate of risk that determines the minimum level of regulatory capital a bank must maintain to deal with unexpected losses. A prudent and credible calculation of RWAs is an integral element of the risk-based capital framework.

In December 2017, the Basel Committee published a number of significant amendments in Basel III: Finalizing post-crisis reforms. These reforms complement the initial phase of the Basel III measures announced in 2010. The 2017 reforms seek to restore credibility in the calculation of RWAs and improve the comparability of banks’ capital ratios. They address weaknesses that were revealed by the global financial crisis and provide a foundation for a resilient banking system that will help avoid the build-up of systemic vulnerabilities. The main changes that will affect banks in the UAE are around changes to calculation of regulatory capital for all Pillar 1 risks, namely credit, market, and operational risk.

### Raising the standard

Most banks around the world and indeed all banks in the UAE use the standardized approach (SA) to determine credit risk capital. Under this approach, supervisors set the risk weights that banks apply to their exposures to determine RWAs. This means that banks do not use their internal models to calculate risk-weighted assets.

Under the recently released Basel changes, it is expected that RWAs for retail customers and financial institutions exposures will rise, thereby requiring banks to hold more regulatory capital against those exposures. The main changes to the SA for credit risk will:

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<tr>
<th>Risk weight</th>
<th>LTV</th>
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<tr>
<td>70%</td>
<td>&gt; 100%</td>
<td></td>
</tr>
<tr>
<td>50%</td>
<td>90% &lt; LTV &lt; 100%</td>
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<tr>
<td>40%</td>
<td>80% &lt; LTV &lt; 90%</td>
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<tr>
<td>30%</td>
<td>60% &lt; LTV &lt; 80%</td>
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<tr>
<td>25%</td>
<td>50% &lt; LTV &lt; 60%</td>
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<tr>
<td>20%</td>
<td>LTV &lt; 50%</td>
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**Residential real estate**

Repayment not dependent on property cash flows.

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Steve Punch is a senior manager in KPMG’s Risk Consulting team.
– Enhance risk sensitivity while keeping the SA for credit risk sufficiently simple

– Provide for a more detailed risk-weighting approach instead of a flat risk weight, particularly for residential and commercial real estate

– Reduce reliance on external credit ratings

– Require banks to conduct sufficient due diligence when using external ratings

– Have a sufficiently detailed non-ratings-based approach for jurisdictions that cannot or do not wish to rely on external credit ratings

For example, under current rules residential mortgages carry a risk weight of 35%, irrespective of loan-to-value (LTV). Under the new rules, LTV will be the determining factor that will drive the risk weight.

**Streamlining treatment**
The financial crisis also highlighted weaknesses in calculating capital requirements for operational risk, or the risk of loss due to inadequate or failed internal processes, people and systems, or from external events. The capital requirements were not deemed enough to cover the losses incurred by some banks. And the sources of such losses – including those related to fines for misconduct or poor systems and controls – are also hard to predict using internal models.

The 2017 reforms were therefore designed to:

– Simplify the framework by replacing the four current approaches with a single standardized approach

– Make the framework more risk-sensitive by combining a refined measure of gross income with a bank’s own internal loss history over ten years

– Make it easier to compare RWAs from bank to bank by removing the options to use multiple approaches or to use internal models

The 2017 Basel III amendments to credit and operational risk are likely to be implemented locally in the UAE on 1 January 2022. They will probably have some impact on processes and regulatory capital values, due to the overall increase on RWAs. Overall, it is estimated that for banks in Europe, this will lower the capital adequacy ratio (CAR) by approximately 50-70 basis points, with a similar effect on UAE banks. The methodology for calculating these values will also require adjustments to systems as well as the collection of additional data requirements.

"The main changes that will affect banks in the UAE are around calculation of regulatory capital, namely credit, market, and operational risks.”