



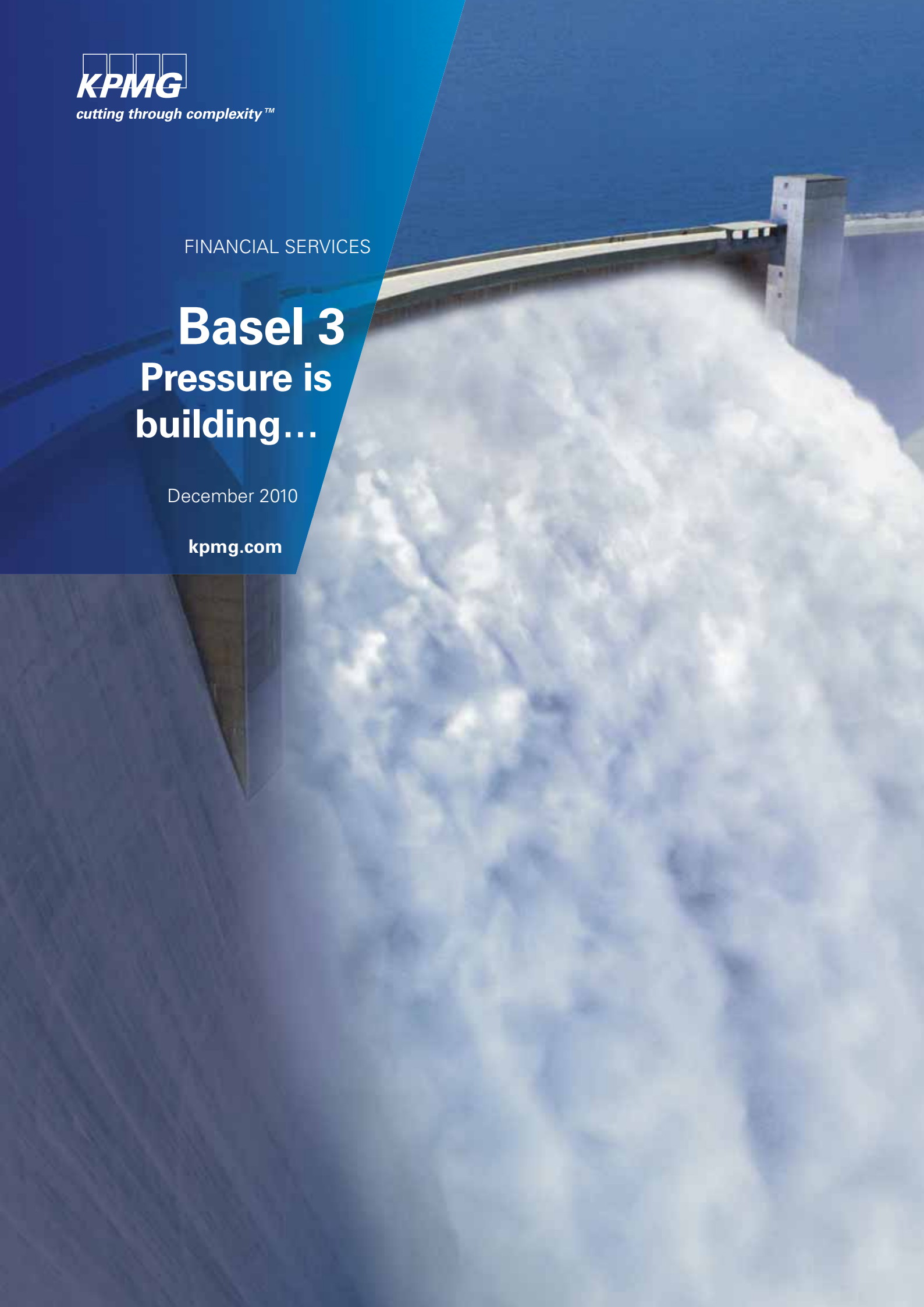
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FINANCIAL SERVICES

Basel 3 Pressure is building...

December 2010

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The G20 endorsed the new 'Basel 3' 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. Basel 3 is here to stay.

The focus of attention is now shifting to implementation – progressing action on the business implications and planning for compliance. There are strong indications that the convergence in principle will become divergence in practice. 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 sooner, and meet interim deadlines along the way.

Despite a lack of absolute clarity, there is no time to waste. Experience from Basel 2 proved that early analysis, strategic evaluation and robust

planning are all crucial to success. Firms must also remain flexible to adapt to subsequent changes and developments, with a number of other parallel policy initiatives being put in place, notably Recovery and Resolution Plans (RRPs), enhanced college of regulator arrangements and continuing uncertainty over tax. Changes in any of these will impact a Basel 3 response plan.

This document seeks to summarise the key details of Basel 3 and explores some of the practical implications and considerations for firms to establish an effective and efficient implementation programme.

Basel 3 - One part of the puzzle

Basel 3 is only one element of a fundamental restructuring of the approach to risk and regulation in the financial sector. Each area of change – governance, supervision, market structure of derivatives and customer treatment to name a few – has a separate consultation, debate and implementation phase. Compared with the implementation of Basel 2, this enhanced level of dynamism, complexity and interdependency within the global regulatory landscape will add significant challenge to the implementation of Basel 3.

The recent G20 Summit in Seoul endorsed the Basel Committee on Banking Supervision (BCBS) agreements on capital and liquidity (Basel 3). The G20 also endorsed the very long transitional periods for full implementation of the Basel 3 proposals.

Despite the G20's objective of establishing a level playing field for banks, the reality is that countries are taking different paths over key issues like governance and remuneration, taxes and levies, the treatment of SIFIs, RRP (or living wills), supervision, and even accounting and disclosure, which is discussed further in KPMG International's recent report *Evolving Banking Regulation: A marathon or a sprint?*

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 3 needs also to be examined in light of the journey back towards financial stability. The prudential soundness of financial institutions is inextricably linked in a mutually reinforcing way to the macro-economic and fiscal soundness of the economies in which they operate.



What are the key outcomes?

Despite the political agreement on the proposals at the G20, significant compromise was seen on the timeline for implementation as well as areas such as the treatment of Minority Interests, Deferred Tax Assets and the calibration of the leverage ratio which were the subject of intense debate between the BCBS and banks. Other key items, such as how to deal with SIFIs has been deferred for the French presidency to resolve.

Much has been made of the increase in the common equity tier 1 ratio from 2% to 7%, mainly that it was less than some policy makers had hoped. However, for business the proposals will be a challenge. While many banks already have ratios above 7% these are based on Basel 2 requirements. The changes mandated by Basel 3 will really add up and even well capitalised banks in Europe and the US could find it demanding. The result could be reduced credit availability or increased cost of credit on the high street.

There was unarguably international divergence over implementation of Basel 2, and the same looks inevitable for Basel 3. Those in the West are focusing on the need for increased buffers for both capital and liquidity. 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. Ultimately, supervisory discretion will influence detailed implementation and leave scope for some jurisdictions to apply a more rigid interpretation of Basel 3 than elsewhere. Political issues and debate around implementation and the operation of supervisory colleges mean 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 FSB has developed general principles, the French presidency will help to define how these will operate in practice, and different jurisdictions are likely to adopt the rules inconsistently for domestic SIFIs, further adding to possible divergence.

A phased in timeline 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. Other organisations should be aware of the reputational and regulatory risks of being perceived as trailing behind in the race to compliance - and respond accordingly.

Much focus has been on the impact on profitability. With common equity requirements more than tripling, estimates of eligible capital reducing by up to as much as 60%, and estimates of risk weighted assets (RWA) increasing by up to 200% or more depending on a firm's circumstances, it seems likely that there will be an impact on return on equity (ROE), the level of which will depend on individual operating models.

Yet, the proposed rules will go far deeper than a simple impact on profitability and ROE. The requirements will have a fundamental impact on business models and the shape of the business done by banks. Some commentators fear – and others welcome – the potential to return to a regime similar to the one that operated a century ago, in which there was limited competition, much less maturity transformation and much less innovation in financial services.

Alongside the proposals for increased regulation in the area of capital and liquidity, is a debate around the degree of intensity of supervision that supervisors apply to institutions. Enhanced supervisory practices will be a major focus of the Basel Committee in 2011. Whether individual countries prioritise the squeezing of firms' business models to drive structural change, or ramp up their supervisory efforts, will have a huge impact on individual financial institutions.

Amongst all of the debate on the new proposals, it is worth noting that the fundamental approach introduced by Basel 2 for determining credit risk weighted assets through internal models has not changed. As with Basel 2, Basel 3 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 which do not are likely to find themselves subject to even greater requirements and scrutiny.

Successful implementation and response must start early, and many institutions have already begun this process in light of the framework now agreed.

Basel 3 is sometimes sold as the solution to the outstanding issues left by Basel 1 and 2. While history doesn't repeat, it sure does show similarities, and it is very unlikely that Basel 3 will be the answer to all the problems. Institutions must therefore retain flexibility to accommodate years of fine tuning and future reforms.

Qualitative impacts of the proposals

Impact on individual banks

Weaker banks crowded out

In a rising tide there were many organisations that could stay along for the ride. As conditions deteriorate and the regulatory position gets ever more intensive, the weaker banks will 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 reorganise and deal with regulatory reform will put pressure on margins and operating capacity. Investor returns will 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 intensive liquidity ratios to address the short and long term nature of liquidity and funding will 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 reorganisation

Increased supervisory focus on local capitalisation and local funding, matched with the treatment of minority investments and investments in financial institutions is likely to drive group reorganisations, 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 failure and also reduced interconnectivity between institutions.

Reduced lending capacity

Although the extended implementation timeline 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 re-build capital bases; ROE and profitability of organisations will 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 inter-bank lending rate.

Inconsistent implementation of the Basel 3 proposals leading to international arbitrage

If different jurisdictions implement Basel 3 in different ways, issues we saw under Basel 1 and Basel 2 with respect to international regulatory arbitrage may continue to disrupt the overall stability of the financial system.



Quantitative impacts of the proposals

All elements of the capital ratio are affected by Basel 3

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 Figure 1, all three parts of this have changed putting more pressure on a firm's compliance with the ratio. The capital ratio requirement has increased; the eligibility of capital has been tightened so reducing the amount of capital firms have to meet the required ratio; and the calculation of risk weighted assets has changed leading to an increase for many organisations.

Managing the potential increase to the RWA figure in the denominator is also crucial to mitigating the impact of Basel 3 on a firm's portfolios. It is very difficult to estimate for each firm, but Figure 2 shows the possible percentage range of increases to the RWA arising from three of the key capital changes in Basel 3, together with some estimate of the percentage range of mitigation of the potential RWA increase that many believe might occur².

In addition, firms face shortfalls in their long term funding needs of up to 50%³ as a result of the new Net Stable Funding Ratio (NSFR) liquidity proposals⁴.

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

Figure 1

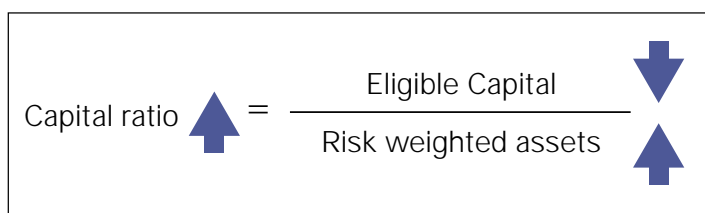
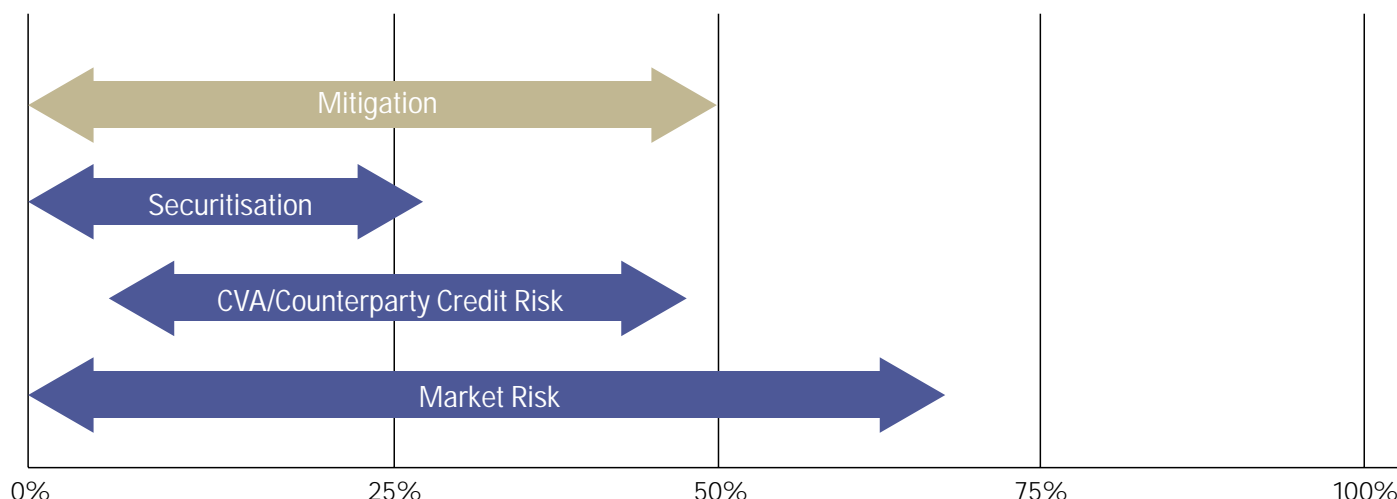


Figure 2

Range of potential increases to RWAs and the possible range of mitigation to the RWA increases



Source: KPMG International, 2010.

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 3 proposals are finalised

What are banks doing to mitigate the impacts?

While it is early days, 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 increased capital ratios in Basel 3 will 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 reorganisation to optimise 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 buy-out minority interest positions to optimise 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, re-structuring into other entities, or development of structured vehicles with investment from external third party capital may help in minimising or hedging counterparty and market risk exposure.

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

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



What is the Basel Committee saying?

According to the BCBS, the Basel 3 proposals have two main objectives:

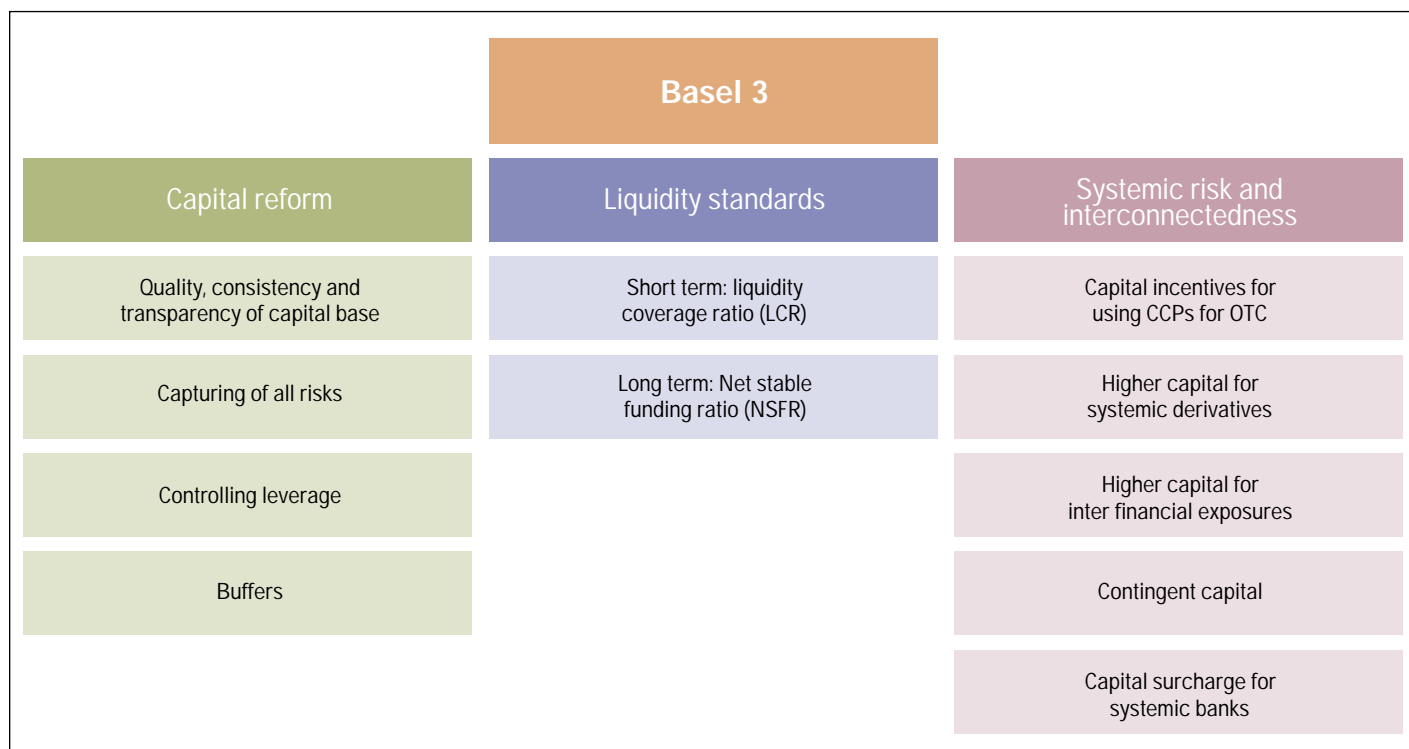
- To strengthen global capital and liquidity regulations with the goal of promoting a more resilient banking sector; and
- To improve the banking sector’s ability to absorb shocks arising from financial and economic stress.

To achieve these objectives, the BCBS Basel 3 proposals are broken down into three main areas (see Figure 3) that 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); and
- Other elements relating to general improvements to the stability of the financial system.

How do the components fit together?

Figure 3



What should firms be considering?

Issues to consider: Capital management

- Carry out appropriate scenario planning and impact assessments to ensure the development of a successful capital strategy.
- Identify which businesses have most attractive fundamentals under Basel 3 - which businesses in your portfolio should you be considering exiting, growing or diverting.
- Ensure management is adequately incentivised to optimise use of capital.
- Defined consistent, quantified capital objectives applied throughout the group.
- Identify what levers can be pulled if needed to fine-tune/lower capital consumption.
- Ensure your organisation is geared up to deliver measurement and management of your capital position and requirements on a sufficiently timely basis.
- Consider how to address the pricing implications arising from changes in the capital requirements for certain products.
- Review whether the same business models continue under a different structure, minimising capital penalties (eg branch versus subsidiary).
- Prepare to be able to meet more accelerated implementation timescales if required.

Issues to consider: Liquidity management

- Ensure you understand your current liquidity position in sufficient detail and know where the stress points are – eg how sticky are your retail and wholesale deposits.
- Ensure management is sufficiently incentivised to optimise use of liquidity. Are transfer pricing or other incentives in place?
- Consider the impact of new liquidity rules on profitability and whether it has been factored into key business processes and pricing.
- Check that liquidity planning, governance and modeling are in line with leading industry practice.
- Determine an appropriate series of liquidity stress tests and how these will change over time.
- Gain awareness of the likely implementation timetable for different elements of the global and national frameworks being proposed.
- Assess your liquidity strategy in light of the existing legal and regulatory structure of your organisation and identify whether the systems, data and management reporting are adequate to meet the requirements.

Issues to consider: General capital planning

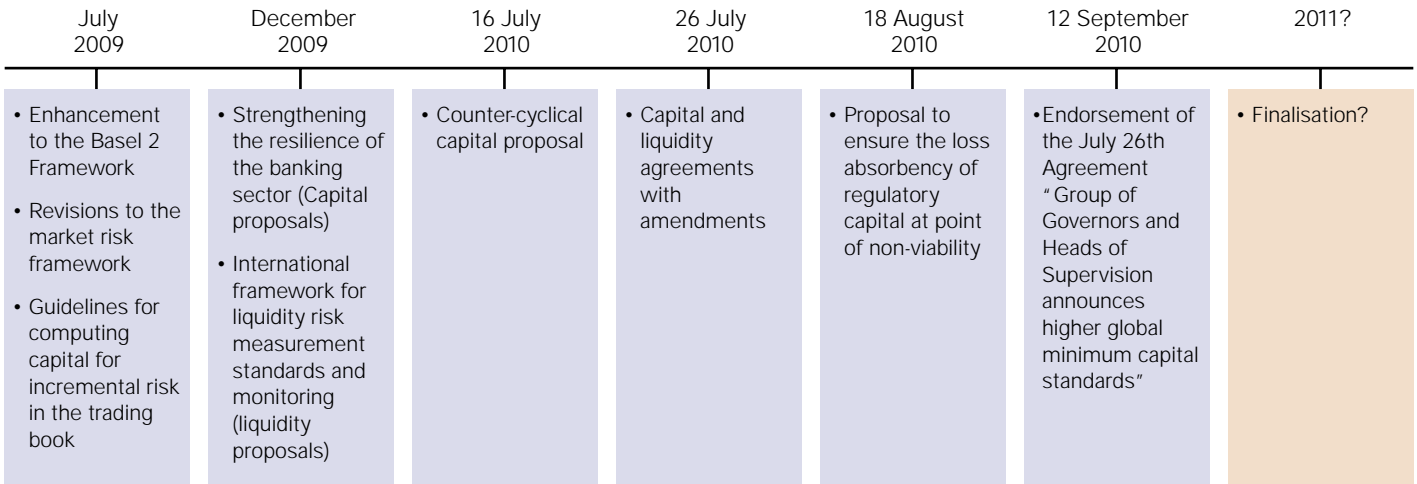
- Ensure you understand and charge businesses correctly for the capital costs of the business that they are doing, focusing your business model on 'capital light' areas.
- Ensure that Basel 3 capital implications are taken into account for new business and consider how existing long-dated business can be revisited.
- Examine how non-core businesses, insurance subsidiaries and other financial institutions can be sold or re-structured.
- Consider the introduction of external capital into specialist structure models to mitigate the capital impacts arising.
- Focus on Basel 2 implications as well as Basel 3 given that Basel 3 amplifies any increases in RWAs arising from Basel 2.
- Examine the performance of your existing assessment methodologies (e.g. IRB models).
- Review your existing data quality – are you missing out on the benefits from collateral information or improved re-rating of obligors due to inappropriate processes.

Timeline for agreement of the Basel 2.5 and Basel 3 proposals

The Basel 3 proposals are incremental to the Basel 2.5 proposals published in July 2009 that have been finalised for implementation in Europe through CRD3 from 31 December 2011. The Basel 2.5 proposals deal principally with the trading book and securitisation positions.

The timeline for agreement of the Basel 2.5 and Basel 3 proposals, outlined in Figure 4, has been extremely rapid compared with the agreement and implementation of the Basel 2 proposals over the period from 1999 to 2008.

Figure 4



Source: KPMG analysis of BCBS

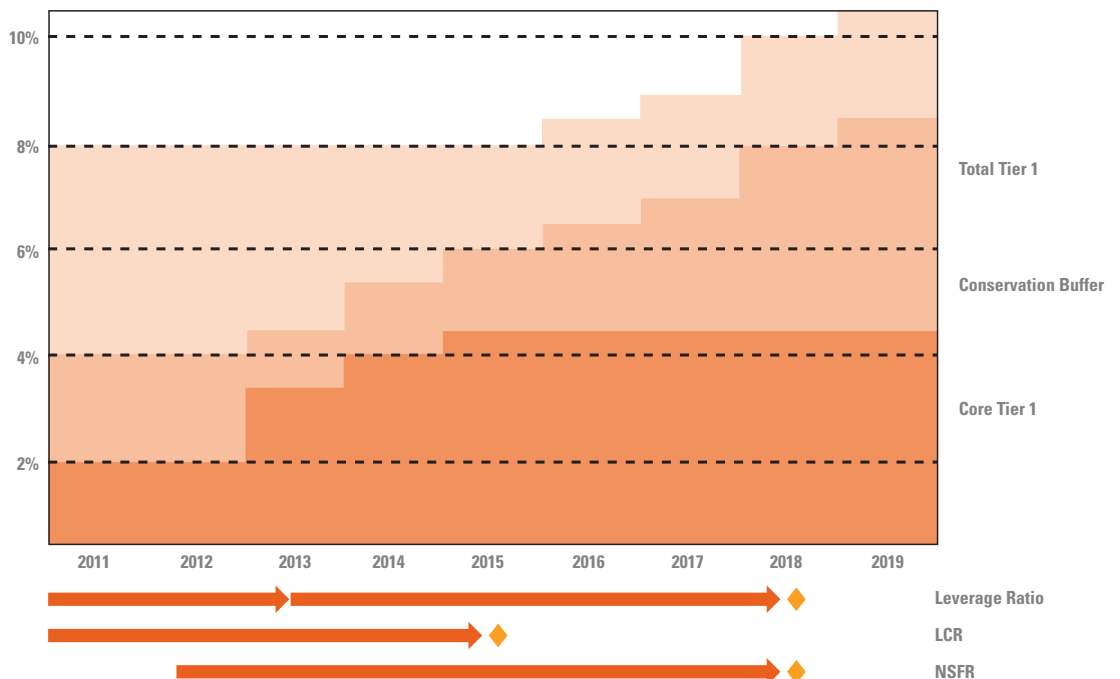
Many detailed elements of the Basel 3 package remain to be finalised in 2011 including the treatment of Credit Valuation Adjustments (CVA) and SIFIs. The Basel 3 proposals will then need to be translated and implemented into national legislation. In Europe, final CRD 4 rules aren't expected until the end of 2011 at the earliest.

The Basel 3 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 Figure 5.

NB – this excludes the implementation of:

- Any buffer for SIFIs. This might be 2-3% for domestic SIFIs and from 5% or more for global SIFIs. The 'Swiss finish' provides for capital requirements up to 19% for its 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

Figure 5
Phased implementation of the key Basel 3 components (excluding the possible buffers for SIFIs and counter-cyclical elements)



Source: KPMG International 2010

The major recommendations and implications

The proposals are structured around the following regulatory objectives, with the key changes and implications highlighted below:

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. **Strengthen 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 hang over from Basel 2, and the structure of their liabilities. Given the rise in capital ratios under Basel 3, previous inefficiencies are amplified and now is the time 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.

1. Increased quality of capital	
Basel 3 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
<ul style="list-style-type: none"> • Common equity and retained earnings should be the predominant component of Tier 1 capital instead of debt-like instruments, well above the current 50% rule • Harmonised and simplified requirements for Tier 2 capital with explicit target for Tier 2 capital • Full deduction for capital components with little loss-absorption capacity such as minority interests, holdings in other financial institutions, DTAs • 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 	<ul style="list-style-type: none"> • BCBS measures are already discounted by markets so banks are likely to clean up their balance sheets as soon as possible • Likely to see significant capital raising by banks along with retention of profits and reduced dividends • National regulators will have less flexibility to allow capital instruments to be included in Tier 1 or Tier 2 capital • Systemically important banks (and potentially all banks) may be allowed to issue contingent convertibles to meet additional capital requirements
2. Increased quantity of capital	
Basel 3 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
<p>Minimum common equity Tier 1:</p> <ul style="list-style-type: none"> • Increased from 2.0% to 4.5% • Plus capital conservation buffer of 2.5% • Bringing total common equity requirements to 7.0% • To be phased in from 2013 to 2019 <p>Minimum total capital:</p> <ul style="list-style-type: none"> • Increased from 8.0% to 10.5% (including conservation buffer) • To be phased in from 2013 to 2019 <p>Counter-cyclical capital buffer being developed which is expected to be implemented by increases to the capital conservation buffer during periods of excessive credit growth.</p>	<ul style="list-style-type: none"> • Banks will face a significant additional capital requirement and the bulk of this shortfall will be need to be raised as common equity, or otherwise by retaining dividends • 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 • 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% • There is likely to be further add-ons for Pillar 2 risks, systemically important firms and the counter-cyclical capital buffer and so banks may target a total capital ratio of 13-15%
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	Implications
<ul style="list-style-type: none"> • The leverage limit is set as 3%, 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 un-weighted basis not taking into account the risks related to the assets 	<ul style="list-style-type: none"> • 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 incentivise 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

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 liquidity coverage ratio 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% for government bonds and cash to weightings of 0%-50% for corporate bonds

Implications

- Risk of impact from bank-run 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

5. Increased stable long term balance sheet funding

The Net Stable Funding Ratio (NSFR) is designed to encourage and incentivise 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% and 5% for cash and government bonds, to 65% for mortgages, 85% for retail loans and 100% for other assets
- For the liabilities, determining stable funding available, the weighing factors vary from 100% for Tier 1 capital to 90% for core retail deposits and 50% for unsecured wholesale funding. ECB funding is weighed at 0%

Implications

- The NSFR incentivises 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 >1 year (limited market demand), which is likely to lead to higher funding costs
- Managing the NSFR by altering the asset mix will 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

6. Strengthen 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 2 framework. Significant increases for trading book and securitisation positions have already been introduced in Basel 2.5 proposals (July 2009) as implemented via CRD3 in Europe which will be effective from 31 December 2011. The Basel 3 proposals primarily modify the treatment of exposures to financial institutions and the counterparty risk on derivative exposures and will be effective from 1 January 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 recent crisis and new capital charges for CVA and wrong-way risk
- "Carrot and stick" approach to encouraging use of Central Counterparties (CCPs) for standardised derivatives
- Improved counterparty risk management standards in the area of collateral management and stress-testing

Implications

- Still a degree of uncertainty over the final capital impact as CVA charge being revised to reflect significant industry criticism
- Controls and quality of 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 business leading to review of business model

Major questions remain

The G20 endorsement of Basel 3 in Seoul is by no means the end of the story. Many items and details within the proposals are not yet finalised, and may not be for some time to come. These include:

- Identifying, defining and treating SIFIs (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; and
- 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 wider unresolved issues at the time of writing which mean that the interaction between Basel 3 and other regulatory reform proposals (i.e. the danger of overlap, duplication and double-counting of treatments) cannot yet be determined.

What does the transformation roadmap look like?

Firms that wish to succeed in a post-Basel 3 environment should have started to consider the implications of Basel 3 already. Figure 6 shows a possible roadmap for consideration.

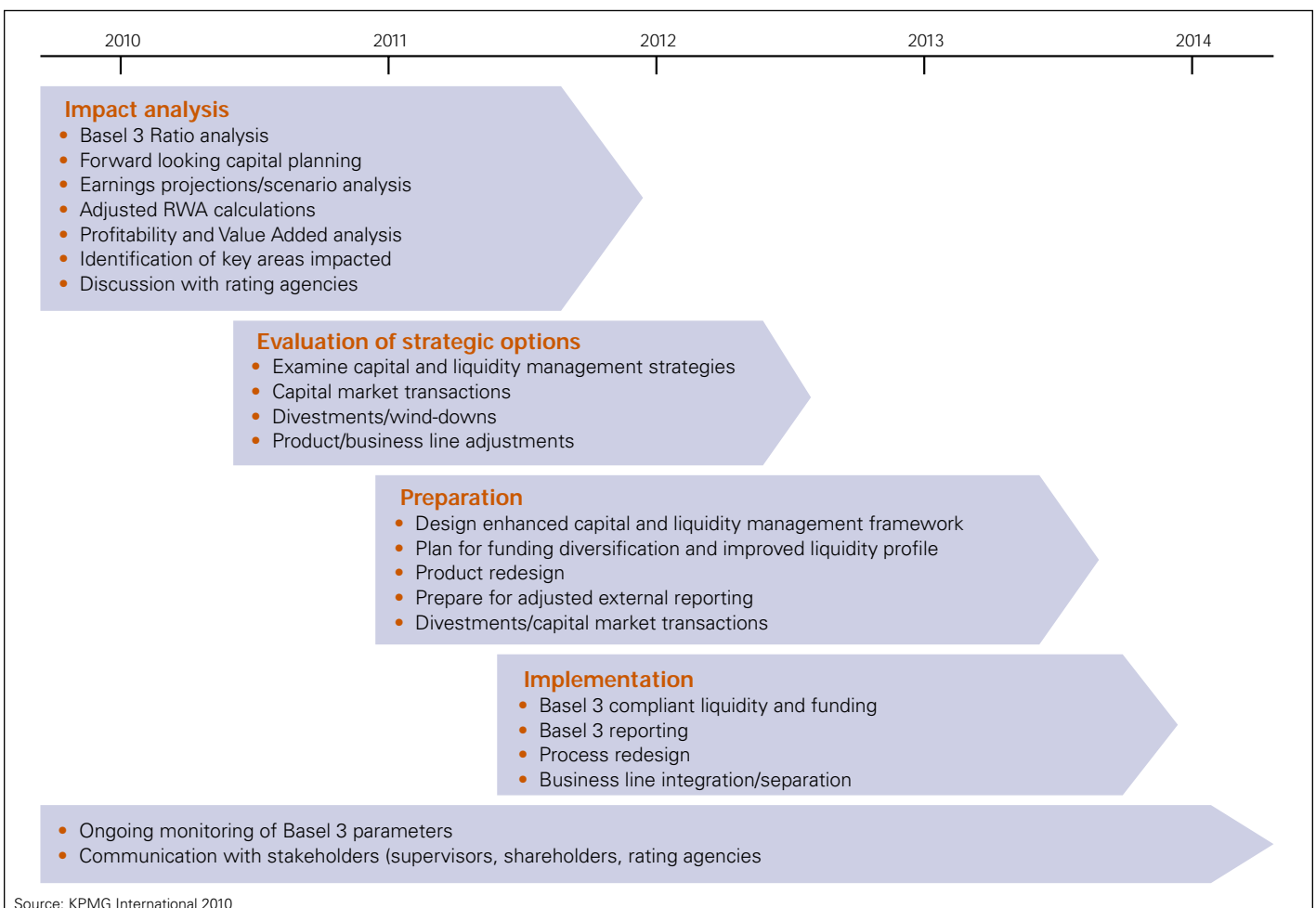
Despite a lack of absolute clarity, there is no time to waste. The Basel 2 experience proved that early impact analyses, evaluation of strategic options and a robust planning and preparation phase are all crucial to

success. Firms must remain flexible to adapt to subsequent changes and developments.

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

Figure 6

Possible phased Basel 3 implementation roadmap



Source: KPMG International 2010

From our firms experience of delivering regulatory change programmes, including Basel 2 and Solvency 2 implementation, a key project team and the qualities of the Basel 3 programme director would include:

Key project team	Key programme director skills
<ul style="list-style-type: none"> • COO • Finance function representative, including CFO • Group risk, including CRO • Regulatory risk/compliance • Regulatory reporting • Group legal • Capital management • IT • Treasury • Core impacted business functions 	<ul style="list-style-type: none"> • Good understanding of bank's operations • Strong links into risk and finance and for risk mitigation into areas such as product design, marketing, capital planning and treasury • Ability to co-ordinate multiple mini-project elements rather than the need to design and implement new core IT systems (contrast with Basel 2) • Understanding of broader regulatory framework • Strong sponsorship from C-level suite to drive necessary changes

KPMG firms can help Conclusion

We are some of the foremost and most experienced advisors in the area of risk, capital and liquidity management. Our firms' risk and compliance specialists bring with them diverse backgrounds in industry, regulations, consultancy government and academia. More widely, our firms' 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 rationalisation and approaches towards provisioning.

We have undertaken major projects for financial sector clients of all sizes and varieties, in many jurisdictions, across a spectrum of issues including:

- impact analysis
- model development and validation
- capital and portfolio management
- liquidity planning
- governance, processes and control frameworks
- valuations
- stress-testing
- portfolio management and rationalisation
- project management office (PMO)
- data quality and management
- strategic business change
- strengthen enterprise-wide compliance programmes

Our integrated approach is aimed at providing a tailored, multi-dimensional service for our clients which meets their specific needs.

The Basel 3 framework introduces another paradigm shift in capital and liquidity standards which was constructed and agreed in, relatively, record time. Many elements remain unfinished and on the face of it the final implementation date looks a long way off. However, market pressure and competitor pressure is already driving considerable change at a range of organisations. Firms should ensure they are engaging with Basel 3 as soon as possible to put themselves in the best competitive position in the new post-crisis financial risk and regulatory landscape.



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