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January 2018

Stand out for the right reasons

Financial Services Risk and Regulation

Hot Topic

'Basel IV': The output floor

Highlights

*On 7 December the Basel Committee on Banking Supervision (BCBS) published its **package of reforms** known as 'Basel IV'. One of the most important, and newly introduced, elements of the package is the output floor, designed to reduce variability in risk-weighted assets (RWAs) and to improve comparability of capital ratios among banks.*

Background and timeline of developments

The BCBS is the international body responsible for setting prudential rules for large, internationally active banks. Since the financial crisis of 2007/09, the BCBS has been updating the Basel II framework to further enhance the risk management and supervision of banks. One of the key components of the 'Basel IV' package is the output floor, which sets a floor in capital requirements calculated under internal models at 72.5% of those required under standardised approaches for calculating capital requirements for all Pillar 1 risks.

The output floor is designed to reduce inconsistency in RWAs not justified by risk fundamentals. The BCBS has been concerned that a range of stakeholders, including academics, shareholders, analysts and market participants have lost faith in the robustness of internal models. In response to these concerns, the BCBS has introduced the output floor as a measure to prevent RWAs and hence minimum capital requirements falling below what it considers an inappropriately low level.

The output floor was the most controversial aspect of the package, with some BCBS members initially resisting the introduction of such a floor due to the increases in capital requirements that will likely entail.

Due to the potential impact of the floor, the BCBS has agreed to implement the floor over a phased-in period of five years. The output floor will be implemented on 1 January 2022 and will initially be set at 50% of standardised capital requirements and then will increased by 5% each year between 2022 and 2026 until it is set at 70% before finally increasing to 72.5% in 2027. The agreement allows national regulators discretion to cap the impact of the floor during the phase-in period (i.e. until 2027) at an increase of 25% increase relative to banks' RWAs calculated without the application of the floor (e.g. if a bank's pre-floor RWAs were 100, but calculated as 130 under the floor, then the RWAs can be capped at 125).

Calculation of the output floor

As outlined by BCBS, when calculating the floors, banks will be required to calculate standardised requirements for the different risk classes as follows:

- **Credit risk**: Banks are required to use the revised standardised approach for credit risk. The floor must be applied at the asset class level and not as an aggregate. This means the floor will have a more pronounced impact on asset classes where the difference between standardised and internal model derived capital requirements are greatest.
- **Counterparty credit risk**: To calculate the exposure for derivatives, banks are required to use the standardised approach for measuring counterparty credit risk (SA-CCR). The exposure amounts must then be multiplied by the relevant borrower risk weight using the standardised approach for credit risk to calculate RWA.
- **Credit valuation adjustment risk**: Banks are required to use the standardised approach for CVA (SA-CVA), the Basic Approach (BA-CVA) or 100% of a bank's counterparty credit risk capital requirement. 'Basel IV' also reformed the treatment of CVA under the Basel framework. Please see PwC's Hot Topic '*Basel IV' CVA- more risk sensitive and granular.*
- **Securitisation framework**: The external ratings-based approach (SEC-ERBA), the standardised approach (SEC-SA) or a risk-weight of 1250% should be used for assets in the banking book.
- **Market risk**: Banks will need to use the standardised approach for market risk. The SEC-ERBA, SEC-SA or a risk-weight of 1250% must also be used when determining the default risk charge component for securitisations held in the trading book.
- **Operational risk**: Banks are required to use the standardised approach for operational risk.

Disclosure requirements

Banks will also have to publish in Pillar 3 disclosures two capital ratios: i) Ratios under the approach for calculating RWAs the bank uses (either standardised or advanced approach); and ii) a ratio which includes the application of the floor. In addition, banks will be required to disclose more granular information on the calculation of their RWAs under the internal model and standardised approaches. These additional disclosure requirements will be set out in forthcoming disclosure templates as part of the BCBS's Pillar 3 disclosure framework.

What is the likely impact of the output floor?

The 'Basel IV' package will need to be implemented in national law and this is likely to be the first major regulatory change to be implemented directly by the UK regulators post Brexit. While there was a lot of resistance in Europe to the output floors, the EU will come under significant pressure to implement the agreement. It is also generally expected that the UK will continue to adhere to international standards following Brexit.

The impact of the output floor will of course depend on business models and the current approach banks use for calculating capital requirements. The impact of the floor will be felt most by those larger banks currently using internal models to calculate a substantial portion of their capital requirements, which have historically resulted in relatively lower RWAs than under the Basel III standardised approaches. For these banks, the floor is likely to result in a significant increase in capital requirements. The phase-in period will help mitigate the impact of these increases, but it is almost certain that analysts and investors will front-run these new requirements in their assessments of banks.

For other banks, not currently using internal models, the floor may result in a more level playing field with those banks using internal models. The biggest challenge for these firms will be the changes required for the implementation of the more complex and risk-sensitive standardised approaches. Please see PwC Hot Topics *Revised Standardised approach for credit risk- Enhancing risk sensitivity* and *Operational risk- a single standardised approach for all.*

Many banks are already strategically looking at their business model. The output floor (and broader range of measures included in the 'Basel IV' package) is likely to recalibrate this process, forcing all banks to critically assess the capital consumption and profitability of different business lines and determine their viability over the medium-term.

What should firms be doing?

- Whilst the proposed implementation timeline appears generous, banks need to analyse the impact and commence implementation planning now. This will require banks to invest time and resources to understand how the package will impact their business model. It is important that banks consider the impact of the output floor on the viability of different business lines.
- Calculating capital requirements under both the internal model and standardised approaches will prove challenging. Banks should use the time before implementation to ensure they have the operational capability to simultaneously calculate and report capital requirements under both the internal model and standardised approaches.

  Banks should engage with the implementation process in the UK and monitor divergence with the agreed Basel standard.

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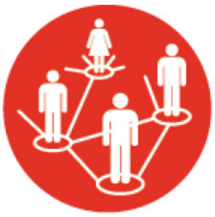
171221-082039-JD-OS

Stand out for the right reasons

Alert

Protect



Adapt

Repair

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