KPMG

PCS Symposium: Basel end game

Basel end game

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Optimisation

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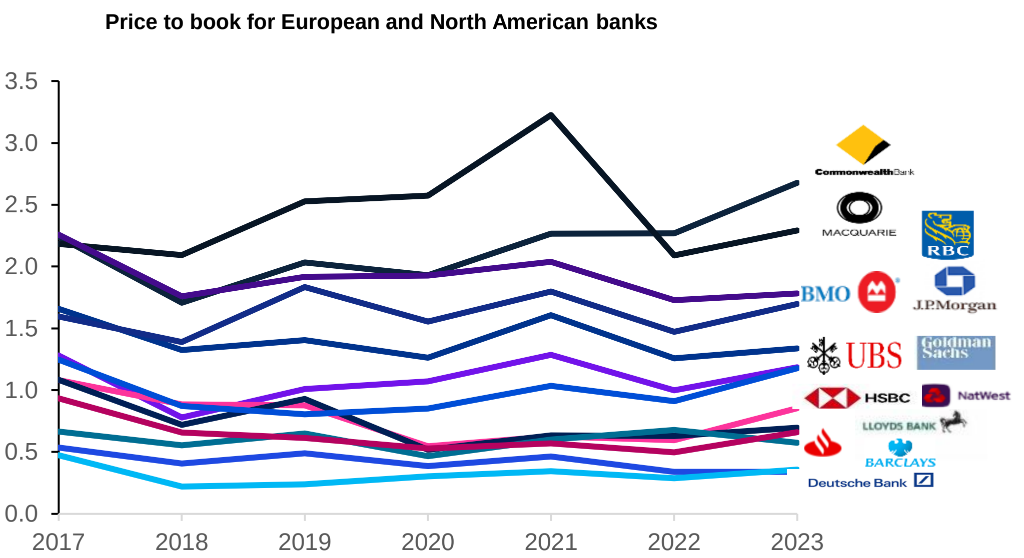
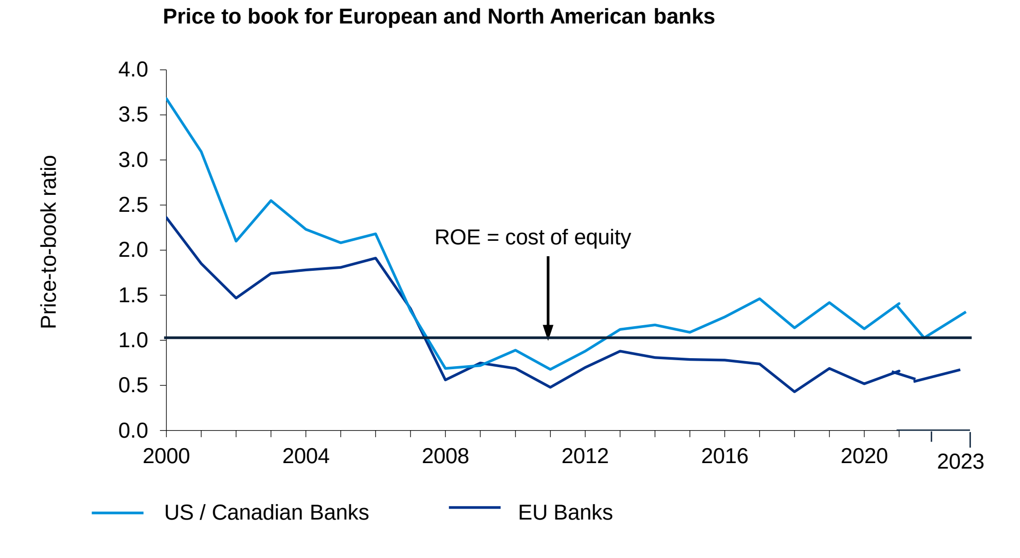
Price to book ratios of UK/EU and US banks

Despite a slight uptick in 2023, large UK/EU banks are generally still trading at a P/B <1 and facing profitability challenges



Source: Y-Charts data (2023)

This is a more general trend with, average UK/EU bank is trading at a P/B ratio of less than 1 and North American banks hovering around a P/B ratio of 1 …



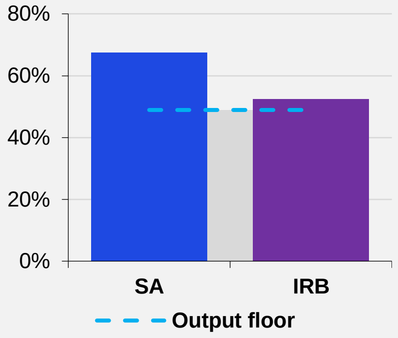
Source: Refinitiv datastream, KPMG analysis (2023)

Portfolio effect: Why is the output floor important?

Example portfolio – Day 1:

- Given the portfolio is below the output floor, the binding capital constraint is the IRB approach RWAs of 52.5% as this is above the output floor of 48.94%.
- This results in a RoRWA of 5.7%

Sub-portfolio	Portfolio weighting	Risk Weight		Intertest rate	RoRWA*
		SA	IRB		
SP 1	50%	100%	100%	5%	5%
SP2	50%	35%	5%	1%	20%
Weighted average		**67.5%**	**52.5%**	**3.0%**	-



48.9%
output floor

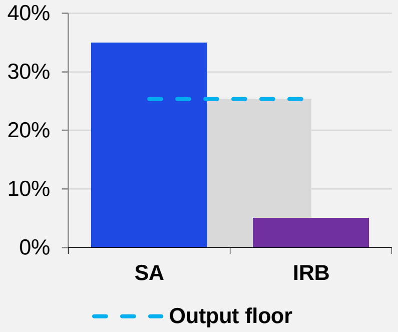
77.8%
IRB : SA

5.7%
Portfolio RoRWA

Example portfolio – Day 2:

- The Bank directs all resources to SP 2 due to the comparatively higher RoRWA.
- Pre-Basel 3.1 this would lower the Banks RWA to 5%. However, post-Basel 3.1 the output floor would result in RWAs that are c5 times higher at 25.4%.
- This results in the portfolio RoRWA falling to 3.9%

Sub-portfolio	Portfolio weighting	Risk Weight		Intertest rate	RoRWA*
		SA	IRB		
SP 1	0%	100%	100%	5%	5%
SP2	100%	35%	5%	1%	20%
Weighted average		**35%**	**5%**	**1%**	-



25.4%
output floor

14.3%
IRB : SA

3.9%
Portfolio RoRWA

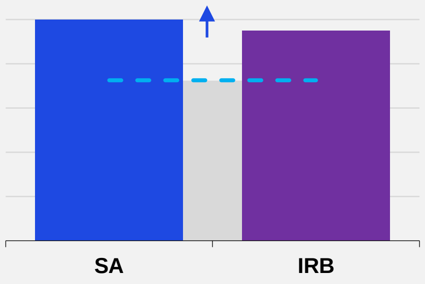
** Sub-portfolio RWA does not consider the output floor*

Efficient frontier for managing the output floor

Implication of being away from the floor…

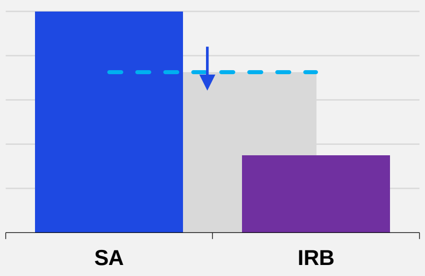
Assuming that internal models more accurately reflect the risk of exposures and the return of assets, there are implications of being far below or above the output floor..

Far above the floor



- Inefficient as incurs the cost of models but not getting a significant capital benefit compared to STD.
- Not playing where there is a competitive advantage.

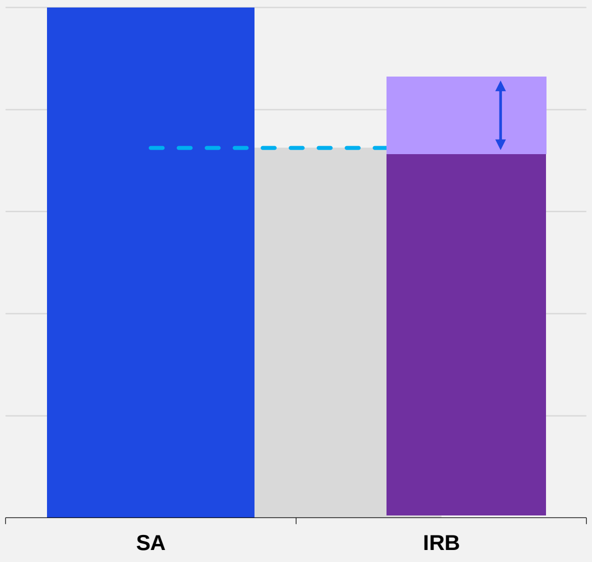
Far below the floor



- Inefficient as this requires holding capital that is not reflective of the risk and for which is not priced.

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:

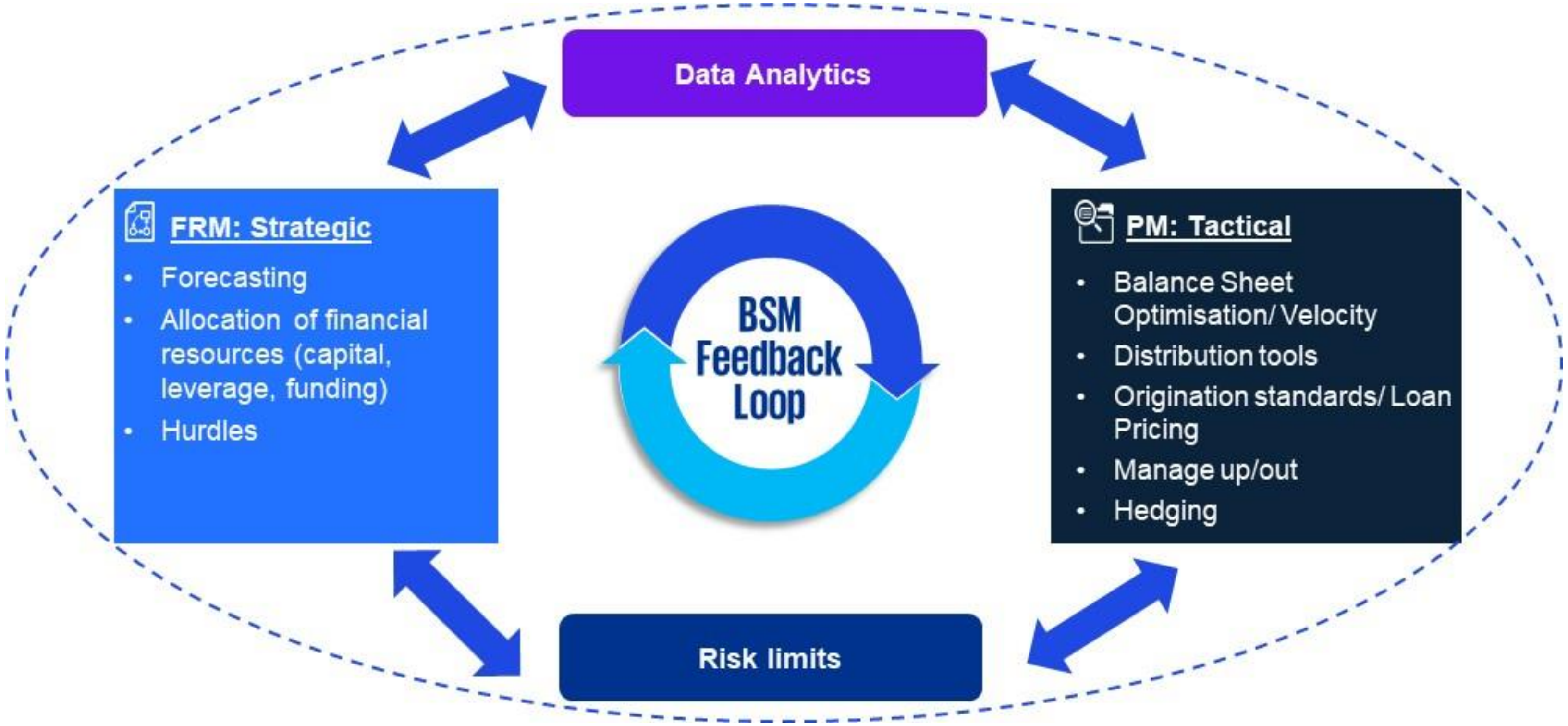


Efficient frontier is to manage portfolio at or slightly above the 72.5% floor level

Limitations on management: results in sub-optimal allocation (above the floor) or need to feed through constrained pricing to BUs

Integrated portfolio and financial resource management

Active portfolio management and centralised portfolio decision-making requires centralised control of the balance sheet within Financial Resource Management (FRM) and Portfolio Management (PM) functions



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

Dynamic, forward looking allocation of resources to increase balance sheet velocity and Return on Equity

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

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

Some or all of the services described herein may not be permissible for KPMG audited entities and their affiliates or related entities.