In the vault with KPMG: Basel III

Elizabeth L'Hommedieu:
Hi everyone. Welcome to today's podcast. I'm Elizabeth L'Hommedieu, a principal in KPMG's Banking & Capital Markets Tax practice. Today I'm joined by some of my Tax and Advisory banking colleagues. We're going to talk about regulatory capital, Basel III and tax regulatory reporting, and some new proposed rules that came out recently. So welcome Grant Dalby and Mike George from KPMG's Banking & Capital Markets Tax practice, and Andrew Devlin from our Financial Services Risk Regulatory & Compliance group. Welcome guys and thanks for being here. So, like I said, today we're going to talk about Basel III and changes that were set forth in a notice of proposed rulemaking very recently released.

But I'm first going to start with a couple fun background facts. Basel III is an international regulatory agreement. It applies to banking organizations and it came out of the Basel Committee on Banking Supervision, which is a consortium of central banks from 28 countries based in Basel, Switzerland. And that's where the name comes from. Now the intent of the Basel regulatory reforms are to ensure that banking organizations maintain certain liquidity and reserve capital in order to maintain the health of our global banking system.

And before we turn to specifics on tax as well as the proposed rule changes, why don't we get a little more background. Mike, at a high level, do you want to talk us through what some of the capital rules are and what these capital computations mean to banks?

Mike George:
First, thanks for having us on to talk about this topic. It's definitely getting a lot of attention in the industry. So maybe to start, for listeners who may not be focused in this area, banks are subject to regulatory capital rules, which are standards for how much capital they must have. This topic is often referred to as Basel III, as it's the Basel III capital guidelines that impact the bank's capital computations and the risk-weighted assets calculation that both factor into the bank's capital ratio. At a high level, the capital ratio is a formula and it's calculated by dividing regulatory capital by risk-weighted assets.

Elizabeth L'Hommedieu:
And then how is tax involved in this calculation, Mike?

Mike George:
Tax should be involved in the process as tax could have a significant impact on the calculations. It is important for the bank's tax department to be in the loop when the bank is going through the process. Tax can impact both the numerator and the denominator of the formula I just went over. For the numerator, which recall is capital, certain DTAs are disallowed from capital. So DTAs that depend on the future profitability of the bank, such as NOLs and credit carryforwards, are deducted from capital. Additionally, timing DTAs that exceed certain percentages of the

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bank's equity are also deducted from capital. And this is important because the smaller the numerator, which is capital, the smaller the ratio becomes and the smaller your capital ratio is, the more problematic it's for the bank.

For the denominator of the fraction, recall that's risk-weighted assets. DTAs that are not subtracted from capital and cannot be carried back are applied at 250 percent risk-weighting, and so those DTAs will increase risk-weighted assets by nature of being risk weighted at 250 percent. And whenever you're looking at a ratio, the bigger the denominator, the smaller the ratio becomes, which results in the banks having a lower capital ratio. So again, tax can impact both the numerator of the computation as well as the denominator.

The process for determining the DTAs that are disallowed is a calculation that the tax departments typically get involved in. At a high level, you start with your GAP DTA, and then you make certain adjustments allowed under the regulatory rules for items such as goodwill, intangibles, and for some banks OCI. You then go through a process of considering carryback capacity and then you finally net DTAs and DTL to get to what I call your regulatory capital DTA. Recall that if a DTA is related to an attribute such as NOLs or credit carryforwards, it's disallowed from capital. If it's related to other timing differences such as your allowance or other DTAs, it's disallowed from capital if it exceeds a certain threshold. If it's not disallowed from capital, it's applied that 250 percent risk weight.

Elizabeth L'Hommedieu:
Thanks Mike, that was a great overview. And if I just summarize, regulators look at the capital ratios to determine a bank's health and predict capital strength in potential future scenarios. So certain carryforwards like NOLs and credits that can't be carried back really can't be monetized quickly, or maybe at all. So, they're disallowed. And other deferred tax assets may be similarly restricted, or risk weighted as part of the calculation in a way that really discounts their value to capital because those deferred assets also may not be easily monetized. Is that right?

Mike George:
Those attributes are only valuable to the extent the bank has future profitability. So for that reason, they're disallowed from capital.

Elizabeth L'Hommedieu:
And what banks are subject to these rules?

Grant Dalby:
Really, all banks are impacted by Basel III and regulatory capital. It's just in different ways depending on the size of the bank. Every bank, big or small, is required to file a call report each quarter with the FDIC and that's going to have quarterly financial information like an income statement or balance sheet, but it's also going to have a section for regulatory capital where the bank would report its regulatory capital information for that period. And then bigger banks, generally starting at the $100 billion asset mark, have to do something called stress testing and that essentially requires the bank to perform a set of forecasted regulatory capital calculations over nine quarters to take into account various adverse economic scenarios that could potentially put stress on the bank's financial condition. And that process is really just intended to support the notion that big banks are financially healthy enough to withstand adverse economic scenarios.

Elizabeth L'Hommedieu:
That's a great overview of the Basel III when it comes to the capital calculations. Now let's turn to the new rule. So, we've got a notice of proposed rulemaking labeled Basel III Endgame, not to be confused with an Avengers movie. And Andrew, I know we've got a thousand-plus pages for potential new regulations, but can you give us a quick overview of what they're trying to address?

Andrew Devlin:
Sure, Liz, happy to share what I know of a thousand pages. What we know is in the proposed rulemaking is the rule is intended to substantially revise the regulatory capital framework for banking organizations with more than $100 billion in total assets and for institutions with significant trading activity. So that would include those smaller firms with $5 billion or more of trading assets and liabilities. The rule is intended to focus on three aspects, the first being credit risk, the second being market risk, and the third being operational risk. I can take you through each of those components, but in totality, the requirement is estimated by the regulators to increase tier one capital for banks by an estimated 16 percent and to provide additional protection for those institutions from losses should they occur in the future.

So, first is credit risk. So, the proposal would adopt what they're calling an expanded risk-based approach for setting regulatory capital requirements for credit risk.

Second, from a market risk standpoint, the goal is to improve risk sensitivity calibration and consistency of internal models that have been used for market risk capital requirements by moving to what's known as a standardized methodology for calculating RWAs for market risk.

And then the third component, which is receiving a lot of attention, is the operational risk capital, which is a proposal to introduce a standardized approach for

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measuring operational risk that would be applicable to all large banking organizations and is intended to increase transparency and comparability of operational risk across the firms. There are other things included in the role that will be of interest to banking organizations that add complexity to disclosure requirements and the regulatory reporting forms that Grant mentioned earlier.

Elizabeth L'Hommedieu:
Can you give us a sense of timing for when these changes might be effective?

Andrew Devlin:
Yeah, so the proposal came out at the end of July. It is open for comment through November 30 where the agencies are asking for market participants to give their input on a list of questions that are included in the NPR. The expectation is that after receiving those comments, the regulators would address the comments and finalize the rule.

Within the rule, they've added a series of different phases to each component of the rule that would provide transition provisions lasting through July 2028. Key among those would be that the three-year phase-in for risk-weighted assets would begin in July of 2025, as would the requirement to reflect accumulated other comprehensive income in regulatory capital, which would also begin in July of 2025. The other elements would be effective as of July 2025.

Additionally, something that's unique to this rulemaking is that the regulators have indicated to industry participants that they would be seeking supplemental data from the industry to help understand how the rule will impact the industry participants. And they'll use that as a means to refine estimates of the rules impact prior to finalizing it.

Elizabeth L'Hommedieu:

So is that request for data then a part of the comment period?

Andrew Devlin:
It'll be run separately. It wasn't explicitly defined within the notice of proposed rulemaking. So, it's something that as they were finalizing the rule, the staff to the Fed board indicated would be forthcoming. So we can look forward to seeing more about that in the coming weeks and months.

Elizabeth L'Hommedieu:
Great. Thanks, Andrew. Let's circle back to tax now and Grant, if we consider the proposed rule changes, what impact does that have on the tax piece of the calculations?

Grant Dalby:
As Andrew said, there's a lot in the proposed rule. But there's really two main changes that we're expecting to have more of a direct impact to the tax calculation. The first item I wanted to touch on was the change to accumulated other comprehensive income or AOCI. This change would affect category III and IV banks, which are banks with total assets between $100 billion and $700 billion. Now, there's a couple of other factors that could put a bank into those categories that we won't get into, but that's the main benchmark to think about. So, Under the current rules, category III and IV banks have historically been able to make an election to exclude certain AOCI items from capital. Typically, the most significant item in AOCI for banks is changes in fair value from available for sale debt securities. In a rising interest rate environment and also in stress testing situations, there's likely going to be losses that are being generated in AOCI, and then an associated deferred tax asset or DTA. Again, under the current rules, category III and IV banks can exclude those items from capital.

Now, under the proposed rules, category III and IV banks would be subject to the same treatment as category I and II, where they would need to include AOCI and capital net of deferred tax. Then the associated deferred tax asset or liability would then be subject to the DTA and DTL netting calculation, which isn't currently the case if an AOCI opt out election is made. In a lot of cases AOCI is going to have a large DTA associated with it. When you put that into the netting calculation, it's likely going to pull away DTLs that are currently getting netted against attribute DTAs which as Mike said, are going to be like items like NOLs and credit carry forwards. It's likely going to result in an increased amount of disallowed attribute DTAs from the capital calculation. And then it's also going to increase the temporary difference DTAs that are subject to that threshold limitation.

Then the other significant item and the proposed rule making are changes related to threshold items. Threshold item is a term that includes assets like mortgage servicing rights, significant unconsolidated investments, and temporary deferred tax assets. So under the current rules category III and IV banks are only required to deduct threshold items from capital to the extent that they individually exceed 25% of common equity tier 1 capital. However, under the proposed rules category III and IV banks would be subject to the same rules as as category I and II in that the threshold items would be deducted from capital to the extent that they individually exceed 10% of common equity tier 1 capital. Then there could also be another deduction from capital to the extent that the remaining threshold items collectively exceed 15% of common equity tier 1. Interestingly, that that change to threshold items does not have a transition period in the proposed rule making and it would be fully effective July 1st, 2025, whereas

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the AOCI change would have a three-year phase in period to be fully effective in 2028.

Elizabeth L'Hommedieu:
So, this sounds like some significant changes for banks between $100 billion and $700 billion of assets. So, they're not able to exclude the AOCI, which as you said, lots of times can be a DTA particularly in those adverse stress scenarios. And in addition, for those threshold items, the percentage is reduced to 10 percent instead of 25 percent.

Grant Dalby:
It is really increasing the amount of DTAs that could be limited and subject to the threshold limitation, which would now be a lower percentage.

Elizabeth L'Hommedieu:
I can see some pretty big impacts for certain calculations as we think about these changes. Mike, what should tax departments be doing now in anticipation?

Mike George:
There are probably a few things that should be on the radar. First, there will need to be some process redesign because as we've walked through, there's going to be some significant changes to the calculation having to add OCI DTAs to the calculation and some changes to the threshold percentage. Additionally, it would probably be wise for banks to do some modeling to understand the impact that these changes are going to have on their DTA and the DTA subject to the capital calculations. As Grant walked through, there are several spots in these changes where it could impact the DTA calculation. I think probably the most significant is going to be the reduction in the threshold calculation from 25 percent down to 10 percent. So not only are you now including the OCI DTA in that calculation, the CET1, which is subject to the threshold calc, is going to be going down for including the OCI losses. You're now taking that smaller number and multiplying it by 10 percent instead of 25 percent and now you're comparing that number to a much larger population of DTAs. So those three things combined are a little bit problematic, especially in stress scenarios. You could see some large DTAs that are subject to and disallowed under the threshold of calc. So, it would be wise, I think, for banks to model the potential implications as if the rules were in place today, and even changes that could be done to mitigate some of the adverse impacts of the DTA and the calculation.

Elizabeth L'Hommedieu:
That makes sense. Mike, that sounds like it's challenging, particularly if you're running spreadsheets for these calculations, having to adjust them for the law changes, but then also making sure those adjustments run through the various scenario calculations that need to be done for stress testing. Do you have any tips or best practices that we should keep in mind for this?

Mike George:
I would say probably the best advice would be to start early. I think some of these calculations can get complex and we've run into changes in the calculation from more tax legislative changes such as the TCJA, the CARES Act, the Inflation Reduction Act. Those all had changes that impacted the DTA calculations that ultimately went through the Basel III deferred tax calculation, but now it's more of a regulatory change that's going to be causing modifications to the spreadsheets and the calculations. So best advice would be to start early so that you can fully vet the changes and model the potential implications. And to that point, KPMG has a software which we refer to as the Basel III deferred tax calculator that specifically is designed to address the Basel III requirements for tax. It can help automate the calculations and quickly compare and contrast results across scenarios. It does a full current calc and deferred calc taking into account the unique rules with credit limitations, carrybacks of attributes, and the alternative minimum tax, and applies the regulatory rules to those DTAs for each period.

Elizabeth L'Hommedieu:
It certainly sounds like having a calculator that makes those changes and pushes them through all your scenarios would be helpful. And I agree with your start early on trying to model out the impacts of all of these changes. So, I want to thank all three of you, Mike, Grant, and Andrew. I appreciate you talking us through this topic today, and I look forward to having you guys back after we see what comes in from the comment period and the data collection, and we can talk through what this final rule looks like and what it means to the Basel III calculations. Thanks again for joining me and to our audience, thanks for listening. This is Liz L'Hommedieu on behalf of KPMG's Banking & Capital.

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