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Basel 3:1 – the final parts of the Prudential reform?

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Today's presenters

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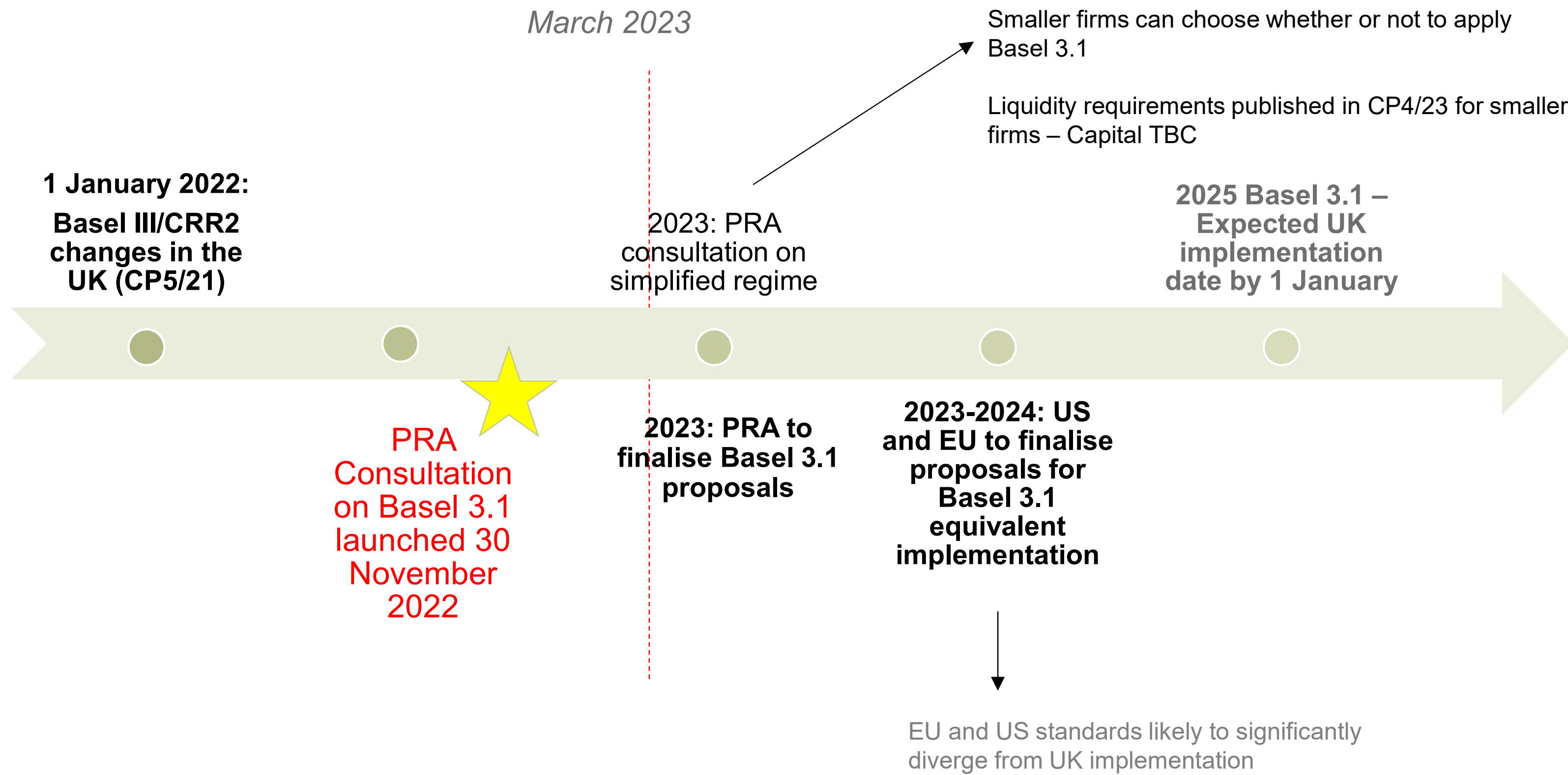
AGENDA

- Basel 3.1 – timelines
- What is Basel 3.1?
- Interaction with the Simplified Firms Regime
- Changes to Residential Property Lending RWAs
- Changes to Corporate RWAs
- Other RWA changes
- Impact of the Output Floor
- Operational Risk Changes

TIMELINES



What is Basel 3.1?

- Basel 3.1 is the PRA's consultation of the final implementation for the Basel 3 proposals.
- The first post-Brexit prudential regulation to be implemented by the UK individually.
- The main changes relate to Pillar 1 capital requirements (treatment of risk weighted assets).
- Firms that use the internal ratings based ("IRB") approach will be subject to an output floor of 72.5% of standardised risk weighted assets.
- Basel 3.1 introduces a more risk-sensitive approach to standardised risk weighted assets.
- Will apply to all UK-regulated Banks and Building Societies although smaller firms will have the option to apply the proposed simplified regime.
- UK's implementation is different from The European Union and the United States. EU/US diverge from the rules and apply more national discretion in the implementation .

Basel 3.1 - What Are the key challenges for firms?

Use of origination values for LTV calculation	New RW for residential real estate	New Credit conversion factor applied to Committed and revolving facilities	SME and Infrastructure supporting factors removed
Lending to unrated corporates – new approach introduced	New asset class for acquisition, development and construction	Treatment of collateral and credit risk mitigation	Level of application of the output floor
CVA adjustment changes	Treatment of equity exposures	No changes to Pillar 2 calculations – 2024 consultation	Pillar 2 offset against P1 headroom

Basel 3.1 Interaction with the simplified regime

Basel 3.1 will go live on 1 January 2025 in parallel with the new simplified prudential regime for smaller firms.

Firms meeting the Simpler-regime criteria on 1 January 2024 can choose to either:

1. Apply the Basel 3.1 standards on the same timetable as other firms to which the new rules, or
2. Apply the Transitional Capital Regime that would be in place until the implementation date of a permanent risk-based capital framework for the simpler regime.

CP16/22 sets out the revised criteria for firms qualifying for the proposed simplified prudential regime:

- £20bn balance sheet size
- Trading business less than £44m or 5% of total assets
- Net foreign exchange position must be equal to or less than 2% of the firm's own funds.
- Exclusion of firms providing certain clearing, settlement, and custody services criterion
- At least 85% of a firm's credit exposures must be to obligors located in the UK

Simplified Regime – liquidity requirements

CP24/3 sets out the proposals for liquidity requirements for firms opting in to the simplified requirement.

The main changes are:

- NSFR replaced with a Retail Deposit Ratio (“RDR”) subject to firms meeting certain conditions
- No liquidity pillar 2 requirements (only for outliers) and reduced ILAAP requirements (new template)
- Reduced reporting requirements including removal of ALMM (C67, C69, C70, C71)
- Removal of Pillar 3 disclosure requirements for non-listed firms. Listed firms are required to report two templates only (UK KM1 and UK OV1).

Changes to Standardised Risk Weights – Real Estate

Key RW% Changes for Real Estate Standardised Exposures

LTV Bands	<50%	50%-60%	60%-70%	80%-90%	90%-100%	>100%
Not materially dependent on cashflows generated by the property						
Loan Splitting Approach	20%	Counterparty risk weight (75% for retail, 85% for SME)				
Materially dependent on cashflows generated by the property						
Whole loan approach	30%	35%	45%	60%	75%	105%

- Residential mortgages not dependent on cashflows are RW use the loan splitting approach.
- Portfolio landlords (3+1 property rule) permitted to use the loan splitting approach.
- Exposures materially dependent on cashflows generated by the property, the RW whole loan will be based on the LTV of the loan.
- RWA% favourable for standard residential mortgages and whole asset class covering Buy-to-let that is slightly more penal for BTL exposures with >60% LTV.
- Firms with IRB model will have RW% floored at 72.5% of standardised RW.
- Exposures not meeting the residential real estate criteria includes care homes, purpose-built student accommodation, and holiday lets.
- Commercial Real Estate is RW% at 100%

Example of loan splitting approach

- For a £80,000 to an individual secured on a property valued at £100,000, the firm would apply a risk weight of 20% to £55,000 of the exposure, and a risk weight of 75% to the residual exposure of £25,000. Total RWAs for the exposure of £29,750 = (0.20 * £55,000) + (0.75 * £25,000).

Changes to Standardised Risk Weights– Real Estate

Definition of LTV is changing

- LTV to be *value measured at origination* (replacing market value) resulting in overall higher LTVs.
- National discretion is permitted but only reflecting downward adjustments and significant modifications.
- Valuation must exclude expectations on price increases and must be adjusted to take into account the potential for the current market price to be significantly above the value that would be sustainable over the life of the loan. LTV will be the *value measured at origination* (replacing market value) resulting in overall higher LTVs.
- National discretion is permitted but only reflecting downward adjustments and significant modifications.
- Valuation must exclude expectations on price increases and must be adjusted to take into account the potential for the current market price to be significantly above the value that would be sustainable over the life of the loan.
- Revaluation is permitted to take place as part of a re-mortgage/product switch.

Changes to Standardised Risk Weights – ADC

- New Asset class for Acquisition, Development and Construction ("ADC") exposures (150%/100% RW)

- 150% RW unless legally enforceable contracts in place:

  a) the exposure meets the prudent valuation requirements; and

  a) at least one of the following conditions is met:

     i. legally binding pre-sale or pre-lease contracts, for which the purchaser or tenant has made a substantial cash deposit which is subject to forfeiture if the contract is terminated, amount to a significant portion of total contracts; or
     ii. the borrower has substantial equity at risk.

Changes to Standardised RISK WEIGHTS (Other)

Key Changes for Exposures to rated Banks/Financial Institutions

External rating of counterparty	AAA to AA–	A+ to A–	BBB+ to BBB–	BB+ to B–	Below B–
"Base" risk weight	20%	30%	50%	100%	150%
Risk weight for short-term exposures	20%	20%	20%	50%	150%

- Limited change as most exposures to remain in 20% band - small benefit as RW% is reduced from 50% to 30% for A+ to A- exposures (typical for treasury purposes).
- Unrated institutions are subject to a new regime ("SCRA") ranging from 40% to 150%. The risk-weight is driven by the counterparty's ability to meet published regulatory requirement and the Firm's assessment of the credit risk of the counterparty.

Other Key changes:

Type	RW%
Equity Exposures not deducted	250%
Subordinated debt	150%
Speculative unlisted equity exposures	400%
Commodity finance	100%
Project finance	130%-80%
Retail Transactors (i.e. credit cards)	45%

Will have impact on some specialist firms

Treatment of Off Balance Sheet Exposures

- Unconditionally cancellable exposures to receive a conversion factor of 10% (previously 0%)
- Off Balance sheet credit conversion factor is changing (including 50% for commitments and 10% for unconditionally cancellable commitments .
- National discretion proposed by the PRA to increase CCF from 20% to 50% for trade related contingent items (Letters of Credit, non-credit guarantees etc).

Changes to Standardised Risk Weights – Lending to corporates

The PRA has introduced a new UK approach for standardised exposures – the risk-based approach.

- Firms can decide to either use the External Credit Rating Risk Assessment approach (ECRA) – currently used in UK/EU as external credit ratings are permitted
- Risk-based approach where external credit ratings are not used

ECRA	Risk-based approach
• Unrated corporate exposures = 100% RW • ECAI rated corporates gets lower RWs (20%-50% for A-rated exposures • Unrated Corporates SMEs = 85% RW • Unrated Retail SME = 75% RW	• Unrated Investment grade corporates* = 65% RW or 135% • Unrated Corporate SMEs = 85% RW • Unrated Retail SME = 75% RW

Impact and challenge:

- SME and infrastructure supporting factors no longer permitted under the standardised approach.
- No doubling up of retail SME (57%).

Introduction of the Output floor and impact on IRB models

- All Firms using IRB models must calculate the output floor based on 72.5% of standardised RWAs.
- Standardised RWAs will therefore become increasingly important for IRB firms.

Capital Floors (72.5% of standardised RWA)

Illustration of output floor calculation — Table 1

	Pre-floor RWAs	Standardised RWAs	72.5% of standardised RWAs
Credit risk	62	124	-
- of which Asset Class A	45	80	-
- of which Asset Class B	5	32	-
- of which Asset Class C (not modelled)	12	12	-
Market risk	2	4	-
Operational risk (not modelled)	12	12	-
Total RWA	76	140	101.5

As the floored RWAs (101.5) are higher than the pre-floor RWA (76) in this example, the bank would use the former to determine compliance with the requirements set out in RBC20.1 (and the buffers in RBC30 and RBC40).

Changes in IRB Model Scope

Revised scope of IRB approaches for asset classes — Table 2

Portfolio/exposure	Basel II: available approaches	Basel III: available approaches
Large and mid-sized corporates (consolidated revenues > €500m)	A-IRB, F-IRB, SA	F-IRB, SA
Banks and other financial institutions	A-IRB, F-IRB, SA	F-IRB, SA
Equities	Various IRB approaches	SA
Specialised lending[3]	A-IRB, F-IRB, slotting, SA	A-IRB, F-IRB, slotting, SA

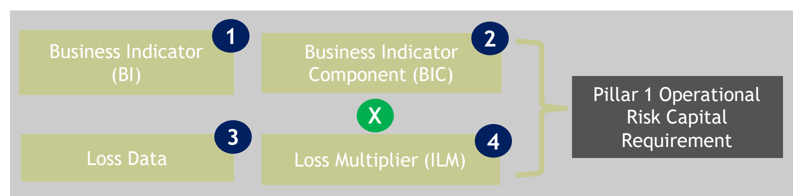
- More stringent approaches for exposures to FIs, 1.25 multiplier i.e. F-IRB model, and equities (no IRB). F-IRB has fixed values for LGD and EAD parameters.
- To remove the option to use the A-IRB approach for institutions/financial corporates and exposures to corporates that are part of consolidated groups that have annual revenues greater than €500m.
- Restrictions on specialised lending
- New exposure classes introduced to align with standardised approach.
- Internal CVA method no longer permitted.
- PD floor of 0.05% introduced for all exposures.

Operational risk – New Pillar 1 Requirement

Key Changes

- New P1 calculation replacing all the current approaches (Advanced, Standard and Basic Indicator).
- Approach is based on two factors; the size of the Firm (Business Indicator) and the loss history.
- Firm with a Business Indicator of <£880m is likely to have reduced requirements as the loss multiplier = 1.
- Firms on a BIA approach are likely to see a small benefit.

New calculation



Business Indicator Component

The BI replaces the current variable gross income used in the current non-advanced approaches. The sum of three components calculated from P&L positions plus balance sheet positions:

1. Lease and Dividend Component (includes 2.25% of interest earning assets)
2. Services Component
3. Financial Component

Business Indicator (€bn)	Weights
1	12%
>1-30	15%
>30	18%

Most firms likely to get a 12% indicator

The LM* is 1 for firms with a BI for all UK firms

Loss Data and Loss Multiplier (LM)

- Loss Component (LC) is equal to 15 times average annual operational risk losses
- incurred over the previous 10 years:
- The LM takes the value 1 if the bank has observed market average operational losses (Loss Component and Business Indicator take the same value).
- In case of above average losses, the multiplier is greater than 1 and thus leads to higher operational risk regulatory capital (and vice versa).

*loss multiplier is set to 1 in the UK

OTHER CHANGES

Regulatory Reporting	Pillar 3	Transitional Provisions	Pillar 2
• New COREP style templates • Limited simplification	• New Pillar 3 templates and removal of some old templates • Pillar 3 guidance excludes simplified regime firms.	• New transitional provisions for firms with a higher Pillar 1 requirement than under the CRR.	• The PRA's approach to Pillar 2 continues to apply • Additional guidance on Pillar 2 and Pillar 1 offsetting

How will B3.1 Impact my firm? Things to consider

Small Banks and Building Societies

- Assess impact of Basel 3.1 vis-à-vis simpler regime.
- What is the benefit cost of new LTV RW% bands?
- Impact of output floor will improve competitiveness for smaller and non-IRB firms.

Firms with IRB permission

- Standardised calculation for output floor likely to increase Pillar 1 capital requirements.
- Standardised requirements to be considered in capital planning and pricing.
- Several models to be excluded from IRB.
- Pillar 2 add-ons and ICGs will be reduced to ensure to overall Pillar 2 increase.

Firms under the standardised approach

- Removal of SME and infrastructure support factors – replaced with lower risk weighting.
- Changes to the treatment of acquisition and development exposures.
- New risk weight to credit card exposures.
- New risk weight to unrated corporates.
- New calculation for trade contingent items.

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