Implications of PRA’s Basel 3.1 proposals on all firms

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Following additional review we have further considered some elements of the Basel 3.1 changes and how they may impact firms.

As part of this review we will consider each of those areas in further detail, exploring the impact that the changes may have on firms capital requirements and how the Prudential Regulation Authority (PRA) is diverging from the European Central Bank (ECB) and even the Basel standards themselves.

The primary objective of the revisions in the current framework is to improve the reliability of capital ratios. This is being done by the following:

- Adding a far greater degree of granularity in risk weighting under the **standardised approach (SA) to credit risk**.
- Complete overhaul of the approach to **operational risk** with the introduction of a new standardised approach.
- Addressing limitations of Internal Models (IMs) for the **internal ratings based (IRB) approach to credit risk.**
- The impact of the reforms on **Pillar 2** remains unaddressed. The PRA is undertaking a review of Pillar 2 which will be completed in 2024.

Credit risk – standardised approach

The PRA has proposed a number of changes to the standardised approach for credit risk which could have significant impact on the risk-weighted assets (RWAs) of UK Capital Requirements Regulation (CRR) firms. **These changes have been designed to address over-reliance on external credit ratings, increase risk-sensitivity and promote effective competition between SA and IRB firms**. This includes additional exposure sub classes; a grading mechanism for unrated corporates; due diligence requirements on the use of external credit ratings; removal of the small and medium-sized enterprise (SME) support factor and reclassification of real estate exposure risk weights. While it is business model dependent, the proposed changes are likely to have a material impact on a number of small and large banks.

Overall, the changes in credit risk can be bucketed into two separate camps. Those that are likely to have a positive (lower) impact on bank capital requirements and changes which are expected to have a negative (higher) capital impact. We’ve set this out in a table below:

	Retail	Wholesale
Positives	• Prime residential mortgages (SA) • Social housing exposures (SA) • Unsecured/retail lending (SA)	• Investment grade (IG) unrated corporates (SA) • Residential development finance (SA)
Negatives	• Retail SMs (SA and IRB) • High loan to value (LTV) second charge and limited company mortgages (SA) • Buy to let, multiple occupation, care home, student accommodation and holiday let mortgages • Prime residential mortgages (IRB)	• Sub-investment grade unrated corporates (SA) • Corporate SMEs (SA and IRB) • Financial corporates and large corporates (IRB)

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There are two changes that appear to be most vexing for firms. The first is removal of the SME support factor. This is likely to increase the cost of capital for lending into this market. The second is reclassification of mortgages which will move some subclasses of mortgages from residential into commercial (higher) risk weights.

Removal of the SME Supporting Factor

The PRA intends to remove the CRR SME supporting factor (which was lending to CRE firms with a turnover below $50mn) and introduce the 'corporate SME' exposure sub-class which will receive a risk weight of 85% (previously 100%). Retail SMEs can qualify for the preferential retail risk weight if they have a wide range of conditions, of 75%. This contrasts with the ECB who are leaving the underlying SME risk weights unchanged (100% for corporate SMEs and 75% for retail SMEs) but keeping the SME supporting factor.

PRA	ECB
• Unrated corporate SME – 85% risk weight • Retail SME – 75% risk weight • Retail Transactor SME – 45/67.5/75/112.5% risk weight (depending on transactor exposures and whether there is a currency mismatch)	• Corporate SME – 100% risk weight (76/85% RWA when the SME support factor is applied) • Retail SME – 75% risk weight (57/64% RWA when the SME support factor is applied) • Retail Transactor SME – 100% risk weight

The split in RWA under the SME support factor is defined by the size of the exposure with SME exposures under €2.5mn receiving the lower RWA treatment.

Given the lower underlying risk weights proposed by the PRA for corporate SME lending, the removal of the SME support factor will have a smaller upwards capital impact than firms may have initially feared. However, there is significant divergence between the PRA and ECB over Retail SME lending and Retail Transactors (this category will cover exposures such as credit facilities and commitments to SMEs). UK firms lending to Retail SMEs are now at a clear disadvantage compared to their European counterparts from a cost of capital perspective.

Reclassification of Retail and Commercial Mortgages

The PRA also proposes to clarify the definition of 'regulatory real estate'. A change that has received less commentary than removal of the SME supporting factor but appears likely to have a more material impact on risk weights across the entire industry.

Under the new rules, **the regulatory real estate exposure risk weights will be determined based on the type of property, the LTV ratio and whether repayments are 'materially dependent on the cash flows generated by the property'**. The PRA has decided that houses in multiple occupation should be treated as materially dependent on the cash flows generated by the property. Buy to Let exposures to individuals with three or less mortgaged residential properties will receive a carve out.

The PRA has further clarified the definition of residential property, excluding care homes, purpose-built student accommodation and holiday lets, which would all be treated as commercial. These changes will result in upwards revisions to the underlying risk weights associated with those categories of lending.

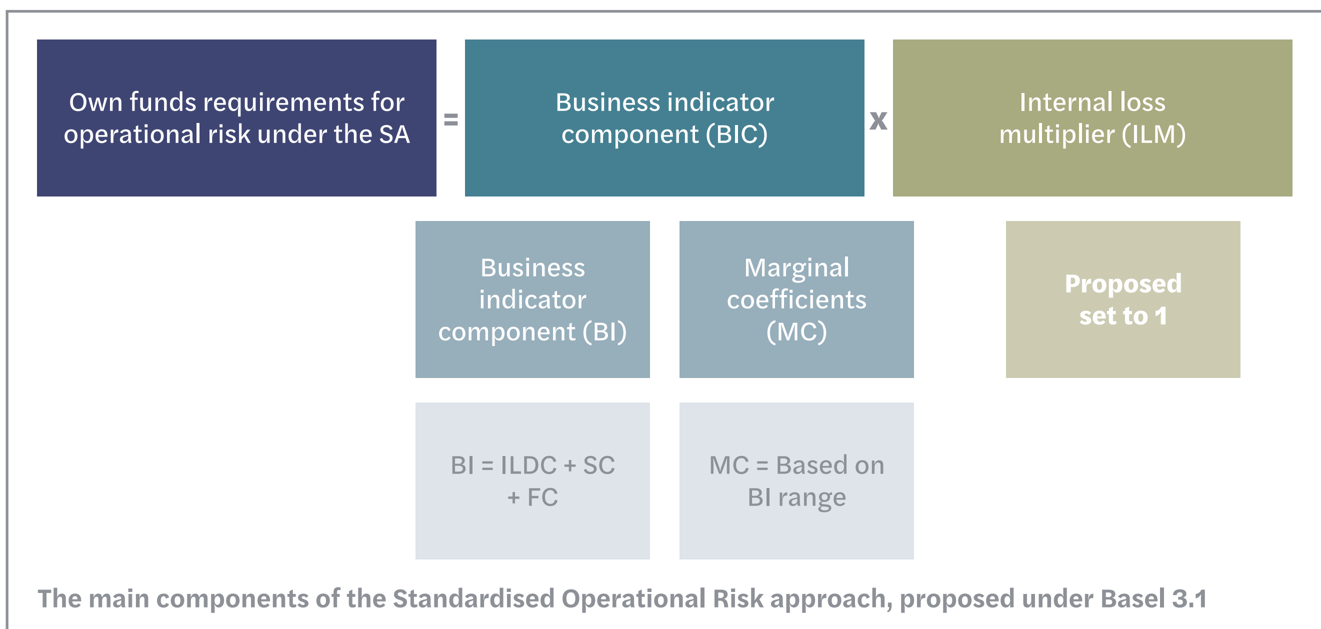
As part of all these proposals the understanding is that the value of the property is fixed at the origination date. This has been done to reduce the risk of excessive cyclicality in property values.

What banks should consider:

- Firms will need to perform gap analysis to understand the implications of the changes in the underlying risk weight calculations and the impact this will have on their Pillar 1 requirements.
- This may be a time for banks to revisit their strategies and consider developing new SME products that are more capital efficient. For example, banks may consider focusing on facilities where obligors are incentivised to repay in full at scheduled periods and not carry a balance, such as charge cards. By incorporating these products in their portfolios, they would lower their cost of capital.
- While the significant focus has been on the removal of the SME support factor, there is a strong likelihood that alterations to the definition of Residential vs. Commercial mortgages will have a more material impact on capital requirements. Understanding this should receive priority when it is business model appropriate.
- Given the increased granularity of the SA, firms should assess their data and risk management capabilities to understand whether any changes will need to be made to optimise risk weight exposures under the new regime.

Operational risk

All existing Pillar 1 operational risk approaches (basic indicator approach, Standardised and Advanced Measurement) are being replaced by a new 'standardised approach' which aims to encompass a firm's size, complexity and historic operational risk performance. The latter is dictated by the **Internal Loss Multiplier (ILM) calculation.** The expectation is that this, more sophisticated approach, is likely to increase Pillar 1 Operational Risk capital.



The main components of the Standardised Operational Risk approach, proposed under Basel 3.1

However, the PRA have decided to set the ILM to 1. By setting the ILM to 1 the PRA are essentially trying to smooth the capital impact of the new requirements. This decision has the effect of neutering a key element of the new SA to operational risk, its risk sensitivity. As a consequence, it is highly likely this will mean that firms will have to continue to hold heighted levels of Pillar 2 operational risk capital to compensate. It is worth noting that the PRA are not proposing to hard code the ILM to 1. Meaning that there is a possibility this figure will change in the future and essentially 'turn on' the risk sensitive element of the SA.

What banks should consider:

- The Business Indicator Component calculation is largely predicated on correct application of balance sheet accounting definitions. Firms will need to perform close analysis of the PRA's proposals to ensure their inputs align to the regulatory expectations.

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Credit risk – IRB

The PRA's IRB proposals largely align with the Basel standards and there is limited divergence between the PRA and ECB on this topic. The focus is on reducing the complexity of the approaches and improving comparability across firms. However, PRA has decided to take a 'gold plated' approach to IRB in some areas where their proposals are more conservative than the Basel standards. This includes the removal of the IRB approach for sovereigns, more conservative input floors (mortgages), and broader application of the asset value correlation multiplier for financials.

Use of the IRB approach has been restricted for low risk exposures including, central governments and central banks and equity, where RWAs will be required to be calculated using the SA. The Advanced IRB (A-IRB) approach is restricted for exposures to institutions, financial corporates and large corporates, where firms will have to use either Foundation IRB (F-IRB) or SA. The A-IRB or F-IRB approaches are no longer permitted for Income Producing Real Estate.

The PRA will grant firms permission to use the IRB approach if they can demonstrate 'material compliance' with UK CRR. This includes permissions for model changes. This is to address a competitive disadvantage for firms aspiring to IRB as firms with permissions already are not required to remediate immaterial non-compliance. Firms can now apply for IRB for some exposure classes while allowing others to remain on the SA. In the past, this mix-and-match approach was not normally allowed.

The PRA has proposed new input floors that generally align with Basel standards, except for the UK residential mortgages portfolio where a more conservative probability of default floor of 0.1% is applied.

What banks should consider:

- For mid-tier firms, the reduced benefit of the IRB approach versus the standardised approach may dissuade application for use of model permissions. Firm's will need to carefully consider whether the advantages of better capital treatment outweigh the time and costs associate with applying for model permissions.
- This will include ensuring that the output floor doesn't become a binding constraint on obtaining any benefits from IRB.
- Firms will also need to consider things like whether the PRA's gold-plated amendments to IRB, such as the removal of the IRB approach for sovereigns, would disproportionately impact them and respond accordingly.
- Firms that continue to use the IRB approach must exercise judgement on the definition of "material" compliance unless it is clarified by the PRA in the coming months.

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Pillar 2

The PRA has disclosed that they intend to review the Pillar 2 capital framework by 2024 at the latest. It is worth noting that these timelines are incredibly tight when aligned with the implementation of Basel 3.1 on the 1 January 2025.

The capital framework is viewed by regulatory authorities holistically. Materially the underlying risk exposure of firms will not have changed either side of Basel 3.1 implementation. Therefore, the overall balance of risk and capital should largely remain the same.

A good example of this can be found in operational risk. Increased requirements in Pillar 1, stemming from the beefed-up standardised approach will likely reduce Pillar 2. However, given the limited risk sensitivity stemming from neutralising the ILM, it appears that requirements in Pillar 2 are likely to remain material. This will likely cause frustration at some firms given the fact that the PRA's Pillar 2 operational risk calculation remains something of a black box with quantitative guidance remaining very sparse.

Another area which may change is credit risk. For firms on the standardised approach there is an open question around whether the increased risk sensitivity of the Basel 3.1 proposals will reduce the need for material Pillar 2 assessments. This may include benchmarking and stress testing analysis.

On the flip side there are some risk stripes that are often linked to calculations based on nominal (for example, non-risk weight dependent) requirements. This includes Interest Rate Risk in the Banking Book, although current circumstances around the failure of Silicon Valley Bank and near demise of Credit Suisse may encourage regulators to revisit this risk type.

Finally, the Bank of England's own, excellent, blog site – Bank Underground – has been openly suggesting that the current calculation of credit concentration risk is inadequate in the calculation of sectoral or geographic add-ons, for smaller firms in particular. Again, given concentration risk is once again front and centre after the collapse of Silicon Valley Bank, this element of Pillar 2 seems ripe for significant overhaul by the regulatory authorities.

For Strong and Simple firms all of this could be moot. These firms can enter the Transitional Capital Regime, with requirements that are substantively the same as the existing Pillar 1 and 2 frameworks in the CRR, until the implementation date for a permanent risk-based capital regime for the simpler regime. The PRA is expected to provide much more detailed guidance around the capital regime for the Strong and Simple framework in 2024.

What banks should consider:

- The PRA is essentially looking to implement the Strong and Simple prudential regime in tandem with the Basel 3.1 reforms. Therefore, smaller firms that may be eligible for both, need to give themselves enough time and resource to run suitable cost/benefit analysis to understand which regime may suit them best.
- Given that the risk-sensitivity of the new standardised approach is being neutralised by the PRA, firms should expect that their Pillar 2 operational risk calculation will continue to be material, from both a qualitative and quantitative perspective, and plan accordingly.
- Firms should be aware of the fact that the PRA's Pillar 2 review may cover risk stripes not directly addressed by the Basel 3.1 implementation, including IRRBB and credit concentration risk. Indeed, these areas may still see the most material changes to supervisory guidance.

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