BASEL 3.1: BRACE FOR IMPACT

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UK FINANCE
2023 ASSOCIATE MEMBER

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REPLY
AVANTAGE

INTRODUCTION TO BASEL 3.1

- The Bank of England has published its position on Basel 3.1 reforms, introducing a series of fundamental changes to the current prudential regulation regime in the UK.
- CP16/22 – Implementation of the Basel 3.1 standards has largely been adopted from BCBS standards and its core principle are aligned to global practices. However, there remain some key points of difference/divergence, specific to the practices in the UK market.

Current state of the Basel 3.1 Proposals

Proposals are under consultation

- *The proposals are currently being consulted on by the BOE and the last day to submit responses is 31 March 2023*
- *There are a few instances where the proposals deviate from BIS and European standards.*
- *These have been highlighted by the BOE and are in-general more prudent than those standards and in BOE's view account for the specificities of the UK market*

Industry Reaction and Approach

Cautious Welcome

- *The basic tenets of the proposals have been known for some time, so the industry has not exactly been caught unaware*
- *Equally, there is a lot to process and analyse and firms have started formal review processes on potential impacts to capital, product offering, data, systems and governance arrangements.*
- *Firms are also considering their next steps in context of the "Simpler" regime expected to be defined in due course.*
- *Avantage reply, being an active voice in the UK Financial Services industry, is also developing responses to the BOE proposal, in consultation with clients, and will be submitting them in due course.*

Major Amendments under Basel 3.1

- Revised SA for Credit Risk
- Revised IRB approach for Credit Risk
- Revisions to the use of Credit Risk Mitigation (CRM) techniques
- Revised approach to Market Risk
- New SA to replace existing IM approaches for calculating OR capital
- New Standardised & Basic Approaches to replace existing IMs for CVA
- Introduction of an aggregate Output Floor (72.5%)

FRAMEWORK EVOLUTION

- **Basel I** focused on Credit Risk and assigned Risk Weights, depending on the level of credit risk associated with the exposure
- **Basel II** introduced operational risk and described the new proposed capital framework as consisting of three pillars:
    - Minimum capital requirements
    - Supervisory review process
    - Market discipline
- **Basel III** enhanced the scope of prudential supervision and covered additional supervisory access.
- **Finalisation of Basel 3.1** framework goes fully into effect in 2025, with adoption of all components by 2030

Output floor change

2025	2026	2027	2028	2029	2030
50%	55%	60%	65%	70%	72.5%

1 — 1988

Basel I

The First Basel Accord was published

2 — 2004

Basel II

2004: Publication of Basel II
2006: Publication of National Regulation with new dispositions on prudential supervision for banks

3 — 2011

Basel III

2011: Publication of Basel III
2013: Publication of CRR I and CRD IV
2014: SSM Go-Live

4 — 2017

BCBS paper

2017: Publication of BCBS paper "Basel III: Finalising post crisis reform"
2017 – 2020: Basel III Framework definition
2019: Publication of CRR II and CRD V
2021: Proposal publication of CRR II and CRD VI

5 — 2022

PS17/21

Revised SA-CCR, IRRBB, Leverage ratio buffer, Exposure to CCP, Large Exposures

6 — 2025

Basel 3.1

Revised SA Credit Risk, SA OpRisk, IRB Framework, CVA Risk Framework, Market Risk SA/IMA

7 — 2030

Implementation phase

Basel 3.1 implementation

KEY CHANGES – CREDIT RISK PERSPECTIVE

In particular for credit risk exposures, there are a number of important changes under standardised approach that need to be carefully considered and analysed in respect of individual business models, product offerings and growth plans in the future.

Risk Sensitivity

Across credit risk categories, increased risk sensitivity through different asset classifications and additional layers of banding (e.g., LTV) has been introduced

Valuation and Indexation Approaches

Proposal to do away with market valuation of real estate through indexation and to base the LTV calculation based on fair valuation of real estate at the point of loan origination

Material Dependence on Cash Flows

Depending on whether an exposure is assessed to be materially dependent on cash flows generated by the underlying property for its repayment, the risk weights have the potential to be significantly higher than the current regime

Interplay of P1 with the rest of the capital stack

The Pillar 2A construct allowed the PRA to consider any under-estimation of P1 risks in the total capital stack. Thus, exposure where P1 risk weights are “lower” compared to the 3.1 regime, the amount of P2A should reduce, given actual risk profile remains unchanged

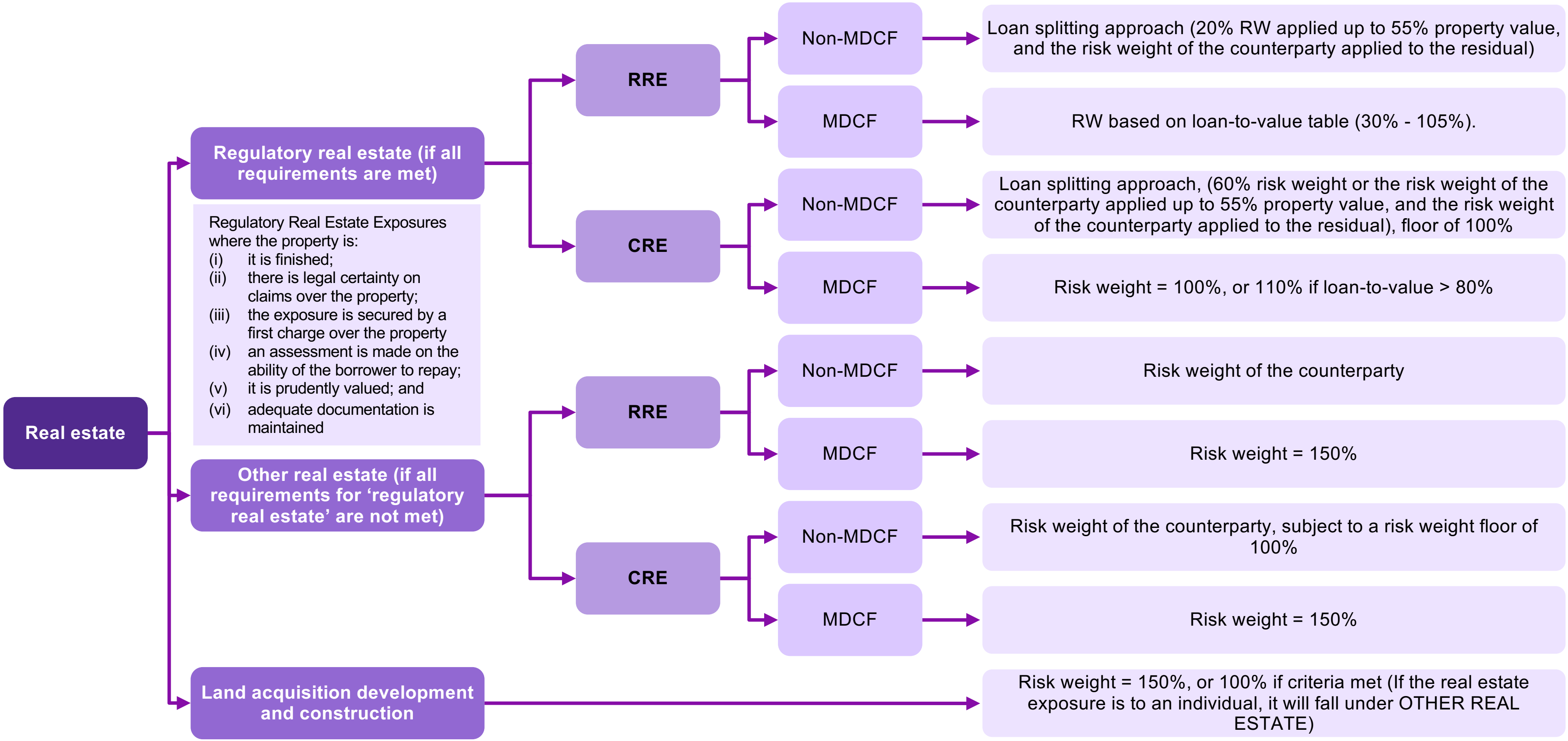
Off Balance Sheet Exposures

Increased risk sensitivity of the regulatory capital requirements for off-balance sheet items

IRB Modelling Approaches

The opportunity to apply IRB modelling approaches in a modular way provides significant opportunities for businesses to undertake internal model development based on their data and be charged bespoke risk weights against their exposures

REAL ESTATE EXPOSURE CLASS ALLOCATION STRUCTURE



MDCF: Materially dependent on cash flows generated by the property, Non-MDCF: Not materially dependent on cash flows by the property, RW: Risk Weight, RRE: Residential real estate and CRE: Commercial real estate

RETAIL & SME EXPOSURE

Introduction of the new sub class and changes to the criteria for identifying regulatory retail exposures (excluding real estate)

Regulatory Retail Exposures (excluding real estate)

a) Product Criteria
- Revolving credits and lines of credit with similar characteristics
- Personal term loans and leases; or
- Credit card facilities and commitments to corporate SMEs

b) Value criteria
- Exposure should not exceed £0.88 million

c) Granularity criteria
- Exposure should not exceed £0.88 million

Retail Exposure Class

- **Transactor (45% Risk Weight)** → Obligors in relation to revolving facilities such as credit cards and charge cards where the balance has been repaid in full at each scheduled repayment date for the previous 12 months; and obligors in relation to overdraft facilities if there have been no drawdowns over the previous 12 months.
- **Non-transactor (75% Risk Weight)** → Retail exposures that do not meet Transactor exposure criteria
- **Other retail (100% Risk Weight)** → Exposures to natural persons that do not meet retail exposure criteria

Small and medium-sized enterprises (SME)

a) Retail SMEs
SME exposure (including undrawn) which meets retail exposure criteria

b) Corporate SME (Rated/Unrated)
SME exposure (including undrawn) which does not meet retail exposure criteria (85% risk weight for unrated Corporate SME)

LEVERAGE RATIO

Changes to the treatment of off-balance sheet items and calculation of the exposures values of derivatives (amendment to SA-CCR) would flow through to the Leverage Framework.

Changes to the treatment and capital levelling of off-balance sheet exposures

- Increased risk sensitivity of the regulatory capital requirements for off-balance sheet items
- Differentiate between commitments to lend or extend credit and unutilised credit that has already been underwritten, such as revolving exposures and lines of credit
- A credit conversion factor is applied to unutilised lines of credit to emphasise the likelihood of a borrower to increase their borrowing during periods of stress
- Credit conversion factor of some of the off-balance sheet exposure is revised upward

The changes to the treatment of off-balance sheet items could potentially impact the Leverage Ratio.

Key changes to the treatment of off-balance sheet items which would impact the Leverage Ratio

CF for the unconditionally cancellable commitments (UCC) is revised to 10%. *(Current CF is 0%)*

CF for Other Commitments regardless of maturity is revised to 40% *(Currently Other commitments are currently assigned a 20% CF if original maturity of less than one year and a 50% CF otherwise)*

CF for self-liquidating trade letters of credit with a maturity of greater than one year is revised to 50% (Currently 20% CF is applied to trade finance documentary credits)

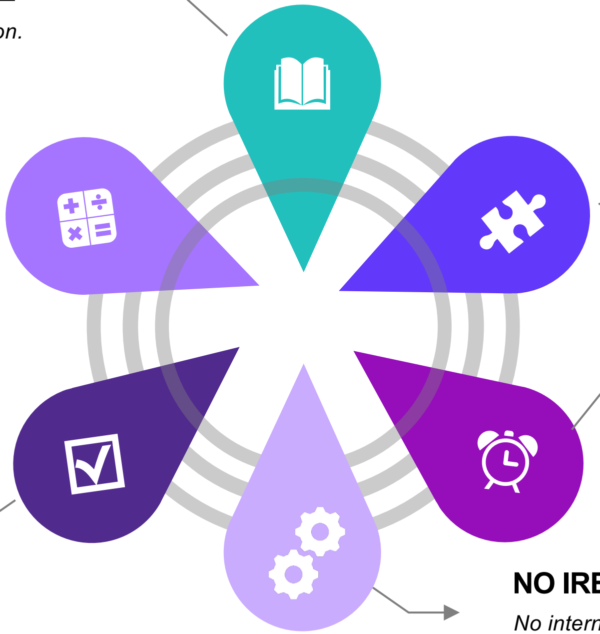
CF of 50% for the 'other transaction-related contingent items' includes guarantees, warranties, and standby letters of credit *(Currently 20% CF is applied to warranties and guarantees)*

Introduction of the Revised definition of 'commitment'. The revised definition is based on contractual arrangements that have been entered into by firms.

SIMPLER REGIME

Firms meeting the Simpler-regime criteria as on 1 January 2024 can choose between being subject to the Basel 3.1 standards, or being subject to the Transitional Capital Regime(TCR). TCR would be in place until the implementation of a capital framework for the simpler regime.

Simpler Regime Firm



SIZE

A maximum size threshold of £20 billion.

LIMITED TRADING ACTIVITY

Off-balance sheet trading business <= 5% of the firm's total assets and £44 Million.

DOMESTIC ACTIVITY

3 year average Credit exposures to UK obligors to credit exposures to obligors in all countries >= 85%

&

Credit exposures to UK obligors to credit exposures to obligors in all countries >=75% at all times.

LIMITED FOREIGN EXCHANGE POSITION:

Net foreign exchange position must be <=2% of the firm's own funds.

EXCLUSION

Exclusion of firms that provide clearing, settlement, custody or correspondent banking services, provide access to an exchange, other trading facility and firms that operate payment systems.

NO IRB

No internal risk based (IRB) approach approval in place

PRA's plan to finalise the Capital Framework for the simpler regime:

- Phase 1 (on aspects of prudential regulation e.g. liquidity regulation), by first half of 2023; and,
- Phase 2 (on capital requirements e.g. Pillar 1, Pillar 2, and buffer), by 2024.

CONSIDERING IRB APPROACH

The PRA proposes to ‘level the playing field’ across lenders by making key changes to IRB adoption requirements.

Permission to use IRB models

Levelling the playing field

- The current CRR regime is disproportionate and puts new firms seeking approval for IRB adoption at a potentially significant disadvantage, relatively.
- The proposal by the consultation paper is to change the requirement for IRB adoption from **“full compliance”** to **“material compliance”**
- As long as the approach results in minimal to no impact on the qualitative and quantitative aspects, the PRA proposes to accept the same as being materially compliant as long as the firm can evidence a plan to remediate any non-compliance within a reasonable timeframe

Roll-out of IRB

Removing barriers to adoption

- The PRA intends to level the playing field for the adoption of IRB models with its proposal to remove the **“Full Use”** requirement, thus making it easier for firms to adopt IRB for selected exposure classes by lenders, in line with BASEL 3.1 requirements
- The PRA proposes new roll-out classes across which firms will be allowed to permanent partial use of SA while adopting IRB for other exposure classes
- The PRA also proposes to allow firms to revert to less sophisticated models in **“Extraordinary Circumstances”**
- The BASEL 3.1 standards also proposes the removal of the scaling factor for the calculation of RWAs, a legacy of the past regime when IRB models were first introduced

Key Steps in IRB model development

1. Assessment
2. Data Collection
3. Model Selection
4. Model Development & Validation
5. Model Calibration
6. Implementation
7. Model Governance & Monitoring

WHAT COULD BE THE NEXT STEPS?

With our deep experience in Basel requirements across Framework, Products, Quantification, Governance and Strategy, we will be delighted to support your firm in considering and executing the relevant business decisions as outlined below;

Key Decision Points

QIS	Product Strategy	IRB Roll-Out	Exposure Classification Rules	Simpler Regime opt-in
Comprehensive QIS studies to determine the precise impact of Basel 3.1 on the full capital stack, including P1, P2A, P2B and buffers, as well as from a leverage ratio, disclosure, data and process perspective	Reviewing product strategies (both back front book) to identify areas of the business where products may need redevelopment or updates, or even exits	Support on IRB roll outs on a portfolio basis	End-to-end review of exposure classification rules to ensure that the logic for classification is embedded in day-to-day operations.	Comparison analysis to evaluate decision regarding a Simpler Regime adoption
Revisions to Pillar 2 approaches	**Risk appetite and Policy updates**	**Terms and Conditions**	**Enforceability of Charges**	**Data Collection**
Initial reviews of P2A approaches to reflect a change in the P1 calculations	Impact analysis on credit lending appetite, risk appetite, limits and triggers, including products where the lending criteria, policies and underlying procedures may require an update	Reviewing detailed product terms and conditions to identify areas which need to be enhanced	Firms are considering whether their legal opinions regarding enforceability of charges will need to be revisited for second charge mortgages	Review both the upstream (collection) and downstream (reporting) impacts from a data perspective

OUR APPROACH TO BASEL 3.1 QIS (QUANTITATIVE IMPACT STUDY)

We have a proven approach and platform to support firms with their regular and adhoc qualitative and quantitative impact assessment of Basel 3.1.

QIS approach to Basel 3.1

1. Understanding the proposed changes

Identify additional data points using the BASEL data model

2. Preparation of data

Prepare data (using existing data set) for CRR II and Basel 3.1 calculation as per data model

3. Perform RWA calculations

Run CRR II and Basel 3.1 calculations on a risk calculator

Run simulations by changing supervisory rules

4. Impact analysis

Use calculation results to assess impact on capital, products, portfolio

Assess business and operational impact due to new standards

5. Response to PRA on QIS & Consultation

Respond to PRA with data driven analysis

6. Readiness for Basel 3.1

Seamless transition to implement Basel 3.1 in time for Jan 2025

OUR TEAM

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Freddy is a co-Founder and Executive Partner of Avantage Reply. He is also responsible or Financial Services vertical, focusing on Business and Technology advisory, strategy and transformation in asset management, banking, and wealth management.

Freddy has worked in financial services in APAC for three years (Vietnam, South China) and in the U.S. (Bay Area and East Coast) for six years before establishing Avantage in London (acquired by Reply in 2011).

Freddy has a strong track record of delivering large and complex business and regulatory transformation initiatives within Banking (Barclays, BNP Paribas, Deutsche Bank, Morgan Stanley, Pictet, RBS, Standard Bank, UniCredit, etc.) as well as Custody / Asset Management Servicing (BNY Mellon, BPSS, CACEIS, RBC IS, JP Morgan, State Street, Schroders, etc.).

Vishwas Khanna
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Vishwas has international FS consulting and risk management experience across Europe, US, Middle East and SE Asia, leading a multitude of risk transformations change programmes.

Vishwas is a trusted advisor to the C-Suite and senior management across a number of financial institutions with strong working relationships with industry associations, and academia and is a speaker at industry events and forums. He is also a member of the Institute of Directors, London. Previously at Deloitte, he led complex risk transformations, Brexit programmes, prudential regulation (ICAAPs, stress testing and risk appetite) and regulatory reporting projects with significant banks (PRA and SSM) and other Financial Services firms.

Vishwas has experience of working with Schroders in relation to your ESG regulatory Compliance programme in Private Assets.

Rohan Wilson
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Rohan is an experienced Senior Project Manager and Regulatory SME with an excellent track record of delivering FS regulatory change and risk management projects in the UK and EU.

He has been working with challenger banks, neo banks and banking license applicants on programme management / project management matters, including for clients owned by PE firms. These projects have included IRB application (self-assessment), prudential regulation, ESG and Operational Resilience.

He has also worked extensively with investment banks, custodians and retail / commercial lenders. He is a former trader (Head of Desk), able to balance regulatory demands with commercial realities.

SELECTED LIMITATIONS

- *The exact impact of Basel 3.1 proposals on your bank and its operations will be dependent on a number of varying factors – so any views or directional estimates presented are merely in the nature of approximations and should not be relied on for decision making purposes. A comprehensive review of products and business model of the firm will be required to form assertive views on the total impacts.*
- *The impacts of Basel 3.1 are wider than those discussed in this pack*
- *Some of the views presented by us in this pack are based on our understanding of observed industry practices. They do not represent the totality of all practices across all banks and should only be considered to be samples or selections.*
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