Basel 3.1: How calculating risk is changing for banks

The Prudential Regulation Authority (**PRA**) recently consulted on how it plans to implement the Basel 3.1 standards in the UK. The Basel 3.1 standards are the remaining parts of the Basel III standards that were to be implemented in the UK, which aim to strengthen the regulation, supervision and risk management of banks. The PRA's proposals in its Consultation Paper 16/22 (**Consultation Paper**) will closely align the UK with international standards by making significant changes to the way firms calculate risk weighted assets (**RWA**). This will alter, amongst other things, the way in which banks calculate the credit and market risk for real estate loans and collateral.

Before the results of the Consultation Paper are published later this year, banks should be aware of the key elements of such standards ahead of the proposed implementation on 1 January 2025 (subject to certain provisions having an additional transition period), and the potential issues the introduction of these standards may bring to the real estate finance market.

Basel 3.1 Standards

The Basel 3.1 standards form part of an agreed set of measures, which aim to increase regulation for banks in response to the global financial crisis of 2007 – 2009.

In the UK, these standards will apply to (amongst others) all PRA authorised banks, building societies and designated investment firms, although some firms that meet the "simpler-regime criteria" definition will be able to choose whether to be subject to the requirements.

The real estate finance market will be primarily affected by the legislation in two ways:

1. the way firms calculate **credit risk**; and
2. the need to introduce **output floors**.

Credit risk

As part of a bank's credit risk analysis, assets are given a risk weighting, which labels the risk profile of that asset. When calculating RWA for credit risk, banks use either the **standardised approach** or the internal ratings-based (**IRB**) approach.

Standardised Approach

Under the standardised approach, banks use a prescribed risk weight schedule when calculating the RWAs for credit risk.

The standardised approach is generally used by smaller firms to calculate their risk weightings. For corporate real estate exposures, the requirements usually mandate a risk weighting of 100%, regardless of the risk characteristics of the loan.

Under the reforms proposed in the Consultation Paper, real estate loans would be divided into two categories, namely:

1. "regulatory real estate exposure" which meet the following six conditions:
   (a) it is finished (i.e. it is fully completed, immovable property);
   (b) there is legal certainty on claims over the property;
   (c) the exposure is secured by a first charge over the property;
   (d) an assessment is made on the ability of the borrower to repay;
   (e) it is prudently valued; and

(f) adequate documentation is maintained; and

2. "other real estate", in cases where the loans do not meet the criteria of a regulatory real estate exposure.

Both categories are further subdivided based on whether the loans are secured on residential or commercial real estate.

For regulated commercial real estate loans, the Basel 3.1 reforms will change the way in which risk weightings are calculated by setting out three 'buckets' for asset categorisation, based on the loan to value ratio (**LTV**) of a loan, with:

1. LTV of no more than 60% being given a risk weighting of 70%;
2. LTV of 60% to 80% being given a risk weighting of 90%; and
3. LTV of more than 80% being given a risk weighting of 110%.

However, the PRA is modifying this in its Consultation by adopting its own 'two bucket' system for regulated real estate commercial estate exposures, with:

1. LTV of no more than 80% being given a risk weighting of 100%; and
2. LTV of more than 80% being given a risk weight of 110%.

Note that where a firm has a junior charge, with senior charges held by third parties, the applicable risk weight would need to be multiplied by 1.25, unless the LTV is less than or equal to 60%.

Accordingly, banks will have to conform to using this new 'two-bucket' system when calculating the risk weighting of an asset, when using the standardised approach.

"Prudent Value"

In addition to determining how real estate loans are to be risk-weighted by UK banks, the standards will also affect how real estate collateral will have to be valued for risk-weighting purposes. The PRA's proposed introduction of LTV-linked risk sensitivity to the standardised approach will have implications on how real estate collateral will be valued. The new standards include (but are not limited to) a requirement for valuations being appraised independently using "prudently conservative" criteria. The Basel III standards don't set out a definition of market value, with the implementation of "prudent value" to be decided at national, regulatory level.

IRB approach

The second approach to calculating risk weightings is the IRB approach, where banks use their internal estimates of borrower creditworthiness to assess credit risk in their portfolios, subject to strict methodological and disclosure standards. The PRA CP proposes to adjust certain requirements to align the IRB approach with the standardised approach.

Minimum output floors

The output floor is one of the key aspects of the Basel 3.1 reforms and will likely drive up the regulatory capital requirements of banks who use the IRB approach.

An output floor sets a lower limit on the capital demands required by banks to calculate credit risk and is intended to ensure that a bank's capital requirements do not fall below a specified level. The introduction of these floors will require banks to calculate their risk weightings using the IRB approach, and then calculate again using the standardised approach. The PRA proposes to implement a firm's output floor as the higher of:

1. the total RWAs, calculated using all approaches that the firm has supervisory approval to use (including internal model approaches); or
2. 72.5% of RWAs, calculated using only standardised approaches.

Such floors are expected to increase over a transitional period. On and from 1 January 2030, if the IRB calculation is less than 72.5% of the risk weighting output of the revised standardised approach calculation, the bank must top up its capital to what would have been required under the standardised approach.

The introduction of minimum output floors, therefore, affects all banks; IRB banks must work out what their risk weightings would be under the standardised approach to see whether they must top up the IRB-calculated capital requirements.

Next steps

The PRA consultation closed at the end of March 2023. While this consultation aimed to improve the current regulatory understanding and limit the disruption caused by the implementation of the Basel 3.1 standards on the real estate finance and valuation sectors, market participants should be aware of the potential consequences for the availability and cost of credit for the UK real estate market. Funders and valuers currently fear that higher risk ratings may ultimately restrict lending and make it more expensive, with borrowing in the real estate sector (particularly in respect of housing and ESG) becoming more costly.

Looking forward, banks will have to make an assessment on how the Basel 3.1 reforms are likely to impact the way they calculate the risk weightings of assets. In particular, banks will have to focus on where the UK proposals diverge from either the Basel standard or the EU proposals.

Banks will also need to consider and account for the significant operational complexity of implementing these reforms across financial, risk and commercial business operations. It will be crucial to have data that is reliable and sufficiently granular for this purpose, as well as change processes that allow for optimal implementation with minimum disruption.

Following delays due to the pandemic, the proposed implementation date for the Basel 3.1 standards is **1 January 2025**, meaning banks have the next two years to assess the impact of the proposals on both their business as a whole and their component businesses and risks.

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