Grant Thornton

Welcome
Banking Breakfast Series
Basel 3.1 Reforms – getting prepared

Tuesday 18 July 2023 | 10:00am – 11:30am

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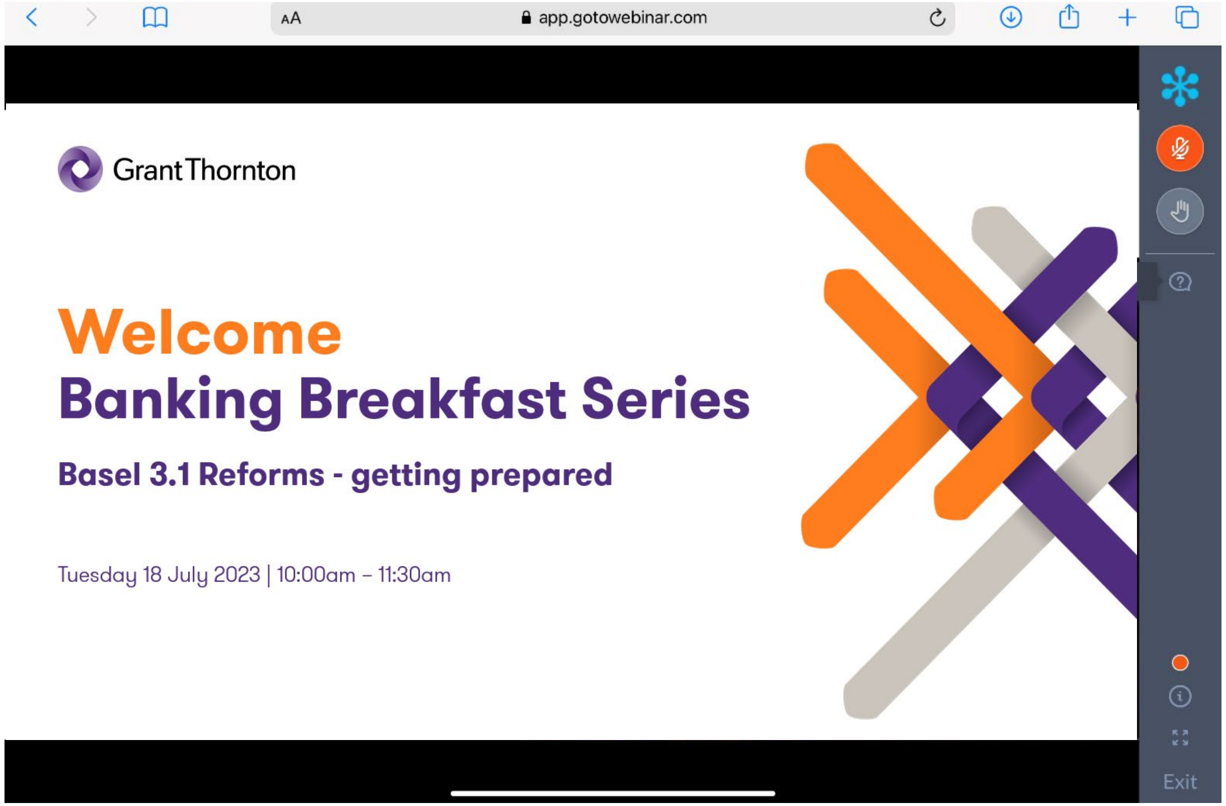

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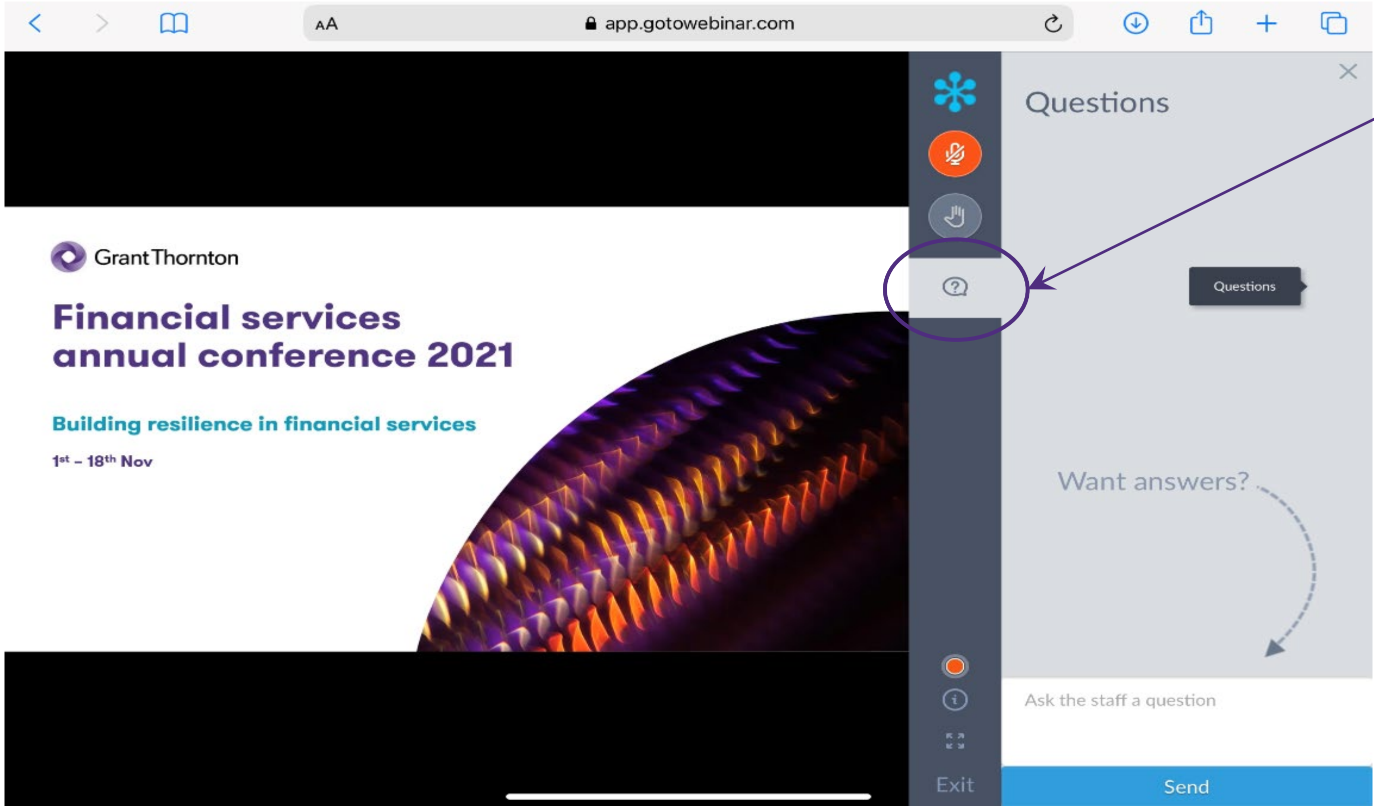

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Introduction

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Agenda

1. Welcome
2. Basel 3.1 getting started
3. Data challenges
4. Concluding remarks
5. Questions

01
Basel 3.1 introduction

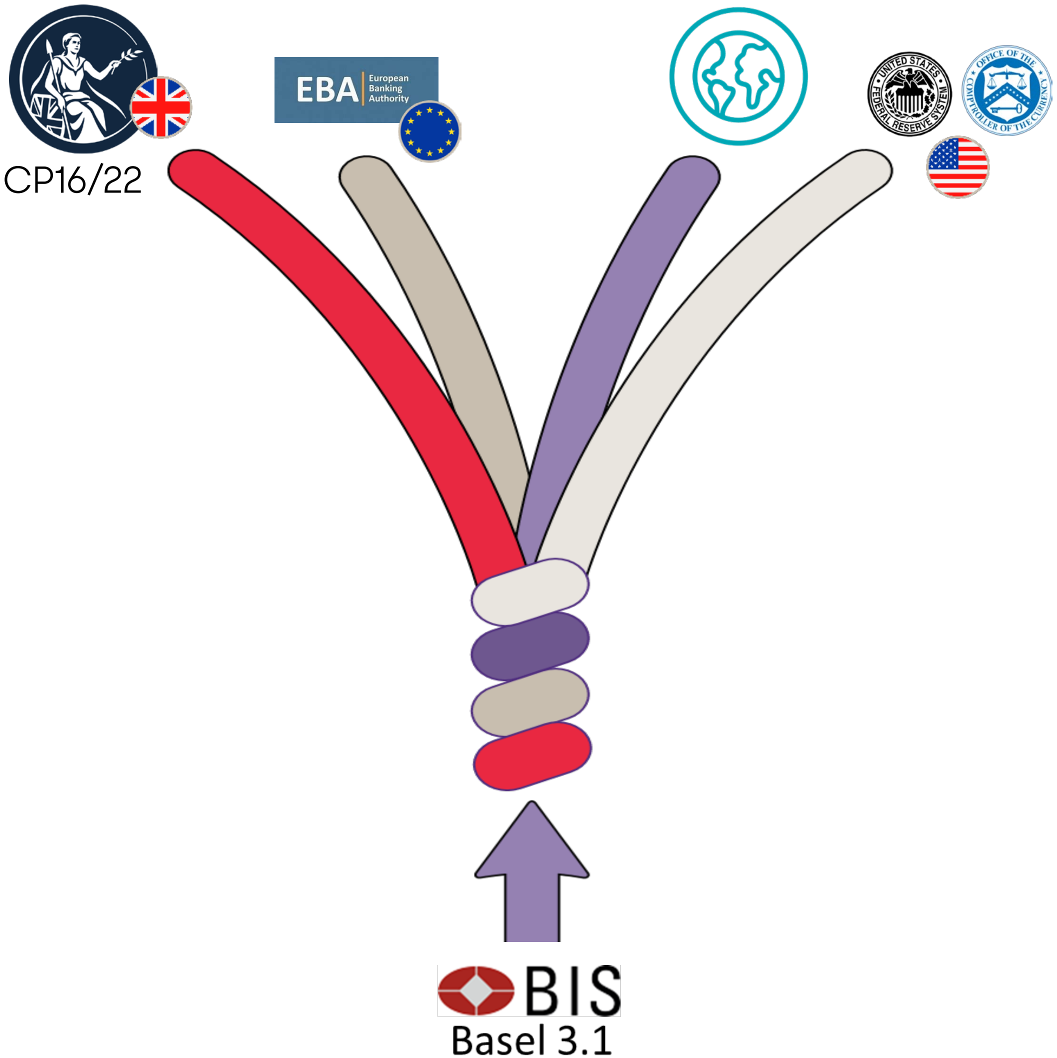
Introduction > Basel 3.1

Basel 3.1, introduced by the BCBS after the financial crisis, strengthens the banking system by improving regulatory capital quality and comparability. It reduces variability in risk-weighted assets (RWAs) to ensure consistent minimum capital requirements and buffers across banks.

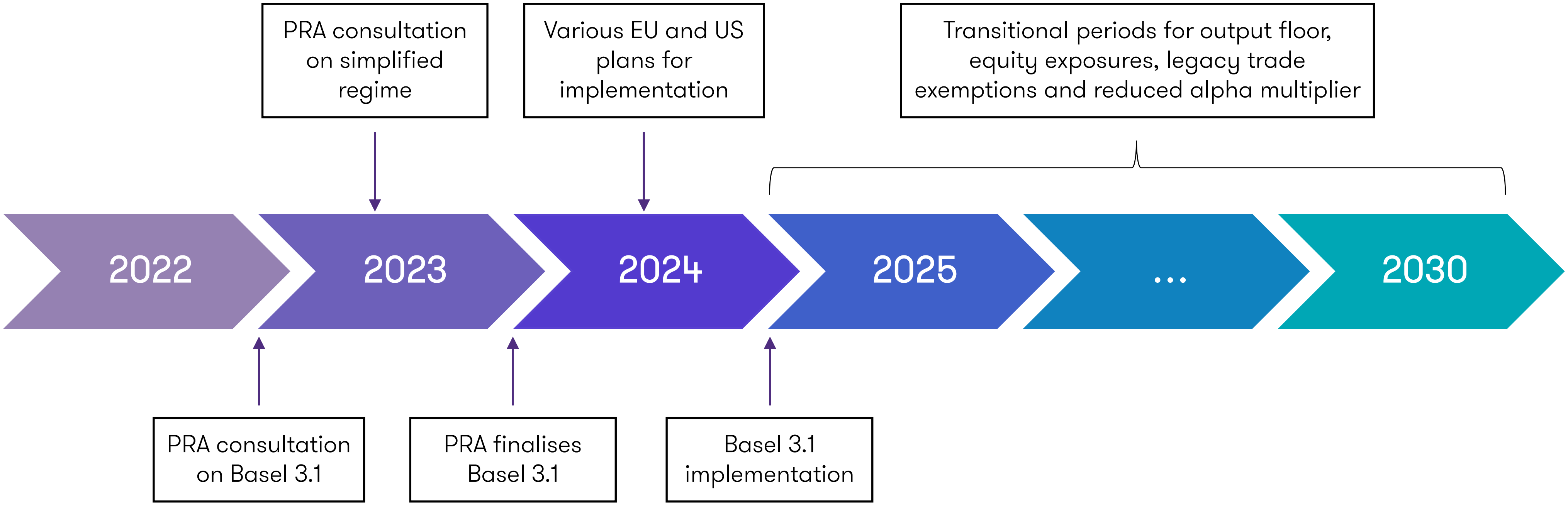
Measures include enhancing standardised approaches (SA), limiting internally modelled (IM) approaches, and setting an output floor for RWAs.

However, implementing Basel 3.1 poses challenges in market, credit, and operational risk frameworks, requiring a review of modelling capabilities, accurate data, and adjustments to reporting processes. Understanding the PRA's Basel 3.1 plans is crucial to meet the January 2025 deadline.

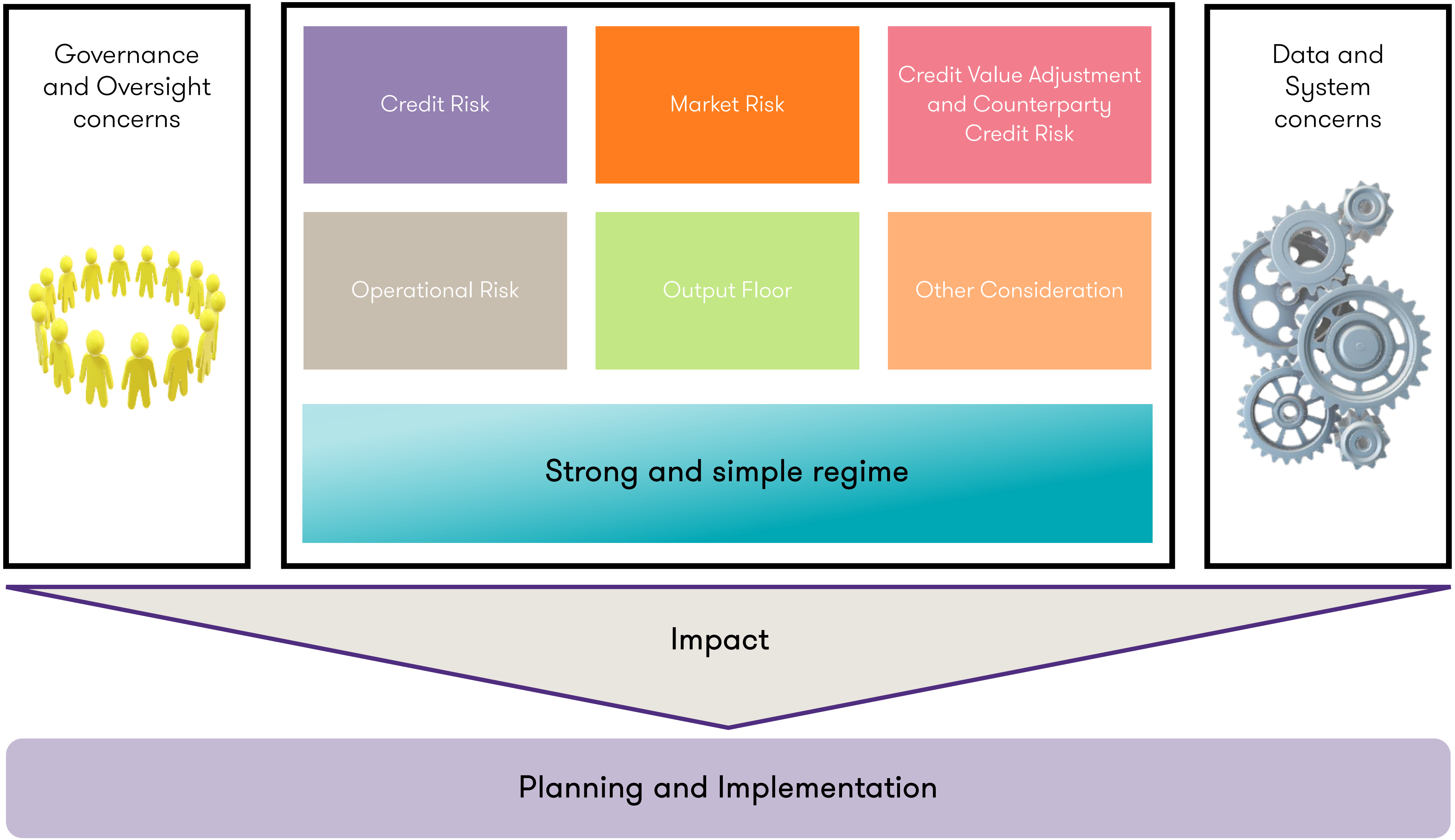
Introduction > Different Regimes



Timelines


PRA consultation on simplified regime
Various EU and US plans for implementation
Transitional periods for output floor, equity exposures, legacy trade exemptions and reduced alpha multiplier
2022
2023
2024
2025
...
2030
PRA consultation on Basel 3.1
PRA finalises Basel 3.1
Basel 3.1 implementation

02
Brief outline of changes


Governance and Oversight concerns
Credit Risk
Market Risk
Credit Value Adjustment and Counterparty Credit Risk
Operational Risk
Output Floor
Other Consideration
Strong and simple regime
Data and System concerns
Impact
Planning and Implementation

Strong and Simple 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

Total balance sheet of up to £20 billion	Limited trading activity	Limited foreign exchange position	No Commodity position	Criteria
No IRB capital requirement approach	Limited business activity	No operating payment systems	Limited non-UK credit exposures (geographical footprint)	

New retail deposit ratio (RDR)	Pillar 2 liquidity	Liquidity reporting	Pillar 3 disclosures	Announced

In a nutshell

Aims to create a more proportionate prudential framework for non-systemically important banks and building societies; discusses liquidity and disclosure requirements, and explores how a simpler regime could boost competition, while maintaining a safe and sound financial system. However, the strong and simple regime sits alongside Basel 3.1, and builds on many of the same themes.

Credit Risk – Revised Standardised Approach

External credit assessment institutions (ECAIs) credit ratings	Consistent use of external credit assessment institutions (ECAIs) credit ratings for all exposure types for risk management and risk weighting
Due diligence requirements	New due diligence requirements for monitoring counterparties and for externally rated exposures (if due diligence shows a higher credit risk than the external credit rating then firms must increase the risk weight)
Removal of SME Support Factor	Remove SME support factor as "imprudent, is not risk-based, and had not materially supported lending to SMEs". Applies to both SA and IRB exposures in retail, corporate or secured by mortgages on immovable property exposures.

Retail exposures excluding real estate	More granular exposure classification, wider range of risk weights , new currency mismatch risk sensitivity factor and threshold updated from EUR 1 million to GBP 0.88 million
Real estate exposures	Introduction of a new "*real estate exposures*" exposure class and more detailed classification of real estate exposures based on exposure type to provide a more precise assessment of risk associated with different types of real estate exposures.
Exposures to institutions	Implementation of a new risk-sensitive approach to assign risk weights, along with changes in base maturity and due diligence requirements.
Exposures to corporates/SMEs	Changes in risk weights, due diligence requirements, a new more risk-sensitive approach for unrated exposures to corporates and a new approach to determine risk weights for issue-specific unrated specialised lending exposures.
Exposures to multilateral development banks (MDBs)	Risk weights as per CQS are introduced for externally rated MDBs (excluding those MDBs eligible for a 0% risk weight). A risk weight of 50% would apply to unrated MDBs.
Exposures in default	Outstanding amount of facility to determine credit risk adjustment threshold instead of unsecured portion of exposure value. For residential real estate exposures where repayments not significantly reliant on property's cash flows, use 100% risk weight.
Exposure to off balance sheet items	Off-balance sheet items have been re-categorised, changes in conversion factors and commitments, as well as self-liquidating documentary credits are further bifurcated into short-term and long-term facilities

In a nutshell

Number of changes to the standardised approach (SA) to increase risk sensitivity, reduce reliance on external ratings and lower variability of risk weights to improve comparability across firms and jurisdictions.

Credit Risk – Internal Ratings Based (IRB) Approach

Restrictions on using the IRB approach to credit risk	• Low default portfolios must use the standardised approach (SA) • Institutions, financial corporates and large corporates exposures must use the foundation IRB (F-IRB) or SA • Income producing real estate (IPRE) exposure class can't use advanced IRB (A-IRB) or F-IRB anymore; only slotting is available under IRB • A new high volatility commercial real estate (HVCRE) category
Changes to input floors	• Input floors won't apply the infrastructure or CRR SME supporting factors • PD input floor is 0.05% except for UK residential mortgage portfolios which are 0.1% • LGD floors range from 5% for residential mortgages and between 25-50% for other unsecured and retail exposures • The PRA has also proposed a dual approach to calculate exposure at default (EAD), depending on the firm's approach to credit conversion factors
Updated definition of default	• The PRA will review its definition of default and update existing guidance in Supervisory Statements and European Banking Authority (EBA) guidelines. It will apply to both SA and IRB firms.
Changes to model governance	• New requirements for data use and maintenance, revised guidance for IRB governance and validation, including specific requirements for the reports produced by a firm's credit risk control unit. The PRA will contact firms individually regarding timelines for submissions, and changes aren't expected until after July 2024.
Greater support for aspiring IRB firms	• These firms can use the IRB approach by demonstrating 'material compliance' with the UK CRR.

In a nutshell

The PRA will implement the internal ratings based (IRB) approach to credit risk broadly in line with the Basel 3.1, but with some amendments to reduce complexity and improve comparability across firms.

Credit Risk – Credit risk mitigation (CRM)

Funded credit protection (FCP)	• Removing some methods under the standardised approach • Changing methods under the foundation IRB approach, including LGD values and collateral volatility adjustments • A new technique under the advanced IRB approach to address insufficient data.
Unfunded credit protection (UFCP)	• Restricting use of current methods in IRB models that adjust PDs or obligor grades • New restrictions on protection recognition methods that are dependent on the credit risk approach used to manage comparable direct exposures to the protection provider.
PRA additions on top of BIS rules	• Introduction of the Foundation Collateral method for F-IRB firms; including a treatment of collateral that is held against multiple facilities not included in Basel • Removal of the Basel F-IRB approach to apply 50% risk weight to certain exposures secured on real estate • Basel standards restrict the use of indirect guarantees to sovereigns only; the PRA have extended it further to include central governments and central banks.

In a nutshell

To enhance the clarity and consistency of the CRM framework, and to address unnecessary complexity in the framework that could result in excessive variability in RWAs and the ability of firms to use internal estimates under the SA, the Basel 3.1 standards introduce a number of material changes impacting the treatment of FCP and UFCP under both the SA and the IRB approach.

Market Risk

Simplified standardised approach (SSA)	For firms with small or simple trading activities, this is a recalibrated and simplified version of the existing standardised approach.
Advanced standardised approach (ASA)	More risk sensitive this includes changes to the gross jump-to-default calculation; a broader data range to evaluate risk positions in collective investment undertakings (CIUs); and a framework for future treatment of carbon emissions trading schemes.
Internal model approach (IMA)	This replaces the current framework and integrates the current risks not in value-at-risk (RNIV) framework (see SS13/13). It also offers more comprehensive calculations involving back-testing for non-modellable risk factors (NMRFs); streamlines and tests for appropriateness of modelling approaches for positions in CIUs; and adapts the treatment of non-trading book foreign exchange (FX) and commodity positions.

In a nutshell

Basel 3.1 builds on existing methodologies to improve risks sensitivities. The PRA model focused approach has new calculation methodologies built within the three categorisation levels for firms (used for all risk frameworks).

Credit value adjustment (CVA) and Counterparty credit risk (SA-CCR)

Basic approach (BA-CVA)	Contains a reduced version with a simplified methodology for firms that don't hedge CVA risk, with a full version for firms that do.
Fall back alternative approach (AA-CVA)	For firms with non-material residual exposure of cleared over-the-counter (OTC) derivative exposures.
Standardised approach (SA-CVA)	Uses three methodologies to estimate the probability of default (PD) by estimating the movement of CVA risk due to changes in the risk factor value and volatility proxy credit spreads. It includes additional scope items (including transition arrangements to increase coverage of sovereigns, non-financial counterparties and pension funds), and calibration refinements (covering relative risk exposure reduction and calculations of PD and expected loss given default).

In a nutshell

New CVA framework replaces the current own funds requirement calculation methodologies with enhanced eligibility criteria for continuity with the proposed revisions to the Fundamental Review of the Trading Book (FRTB). The proposals also adjust the calibration of the standardised approach for counterparty credit risk (SA-CCR) where the PRA considers it to be overly conservative.

Operational Risk

In a nutshell

The current operational risk approaches, namely the Basic Indicator Approach (BIA), Standardised Approach (SA), and Advanced Measurement Approach (AMA), will be replaced with the new Standardised Approach (SA).

Description	Own funds requirement			
Elements	Basic Indicator Component (BIC)			Internal Loss Multiplier
Approach	Basic Indicator (BI)	X	Marginal Coefficients (αi)	Set to 1 per national discretion

Output floor

$$Total\ RWA = \max\{RWAs(all\ approaches), 0.725 * RWAs(SA\ only)\}$$

In a nutshell

The output floor is intended to promote the safety and soundness of firms with IM permissions, and to facilitate competition between SA and IM firms.

Firms determine their Risk-Weighted Assets (RWAs) by selecting the higher value between:

1. Calculating total RWA using all approved approaches, including internal models
2. Calculating 72.5% of RWAs using the standardised approach alone.

The latter option is referred to as the "output floor" or "floored RWAs."

The requirement is to be phased in over five years

SA RWA	72.5% of SA RWA	IRB RWA	IRB RWA Floor
1,000	725	680	725

03 Planning and impact assessment

Planning

Basic Compliance → Alignment → Improvement

Planning and Assessment

- Gap analysis
- Impact analysis
- Audit and assurance reviews

Implementation

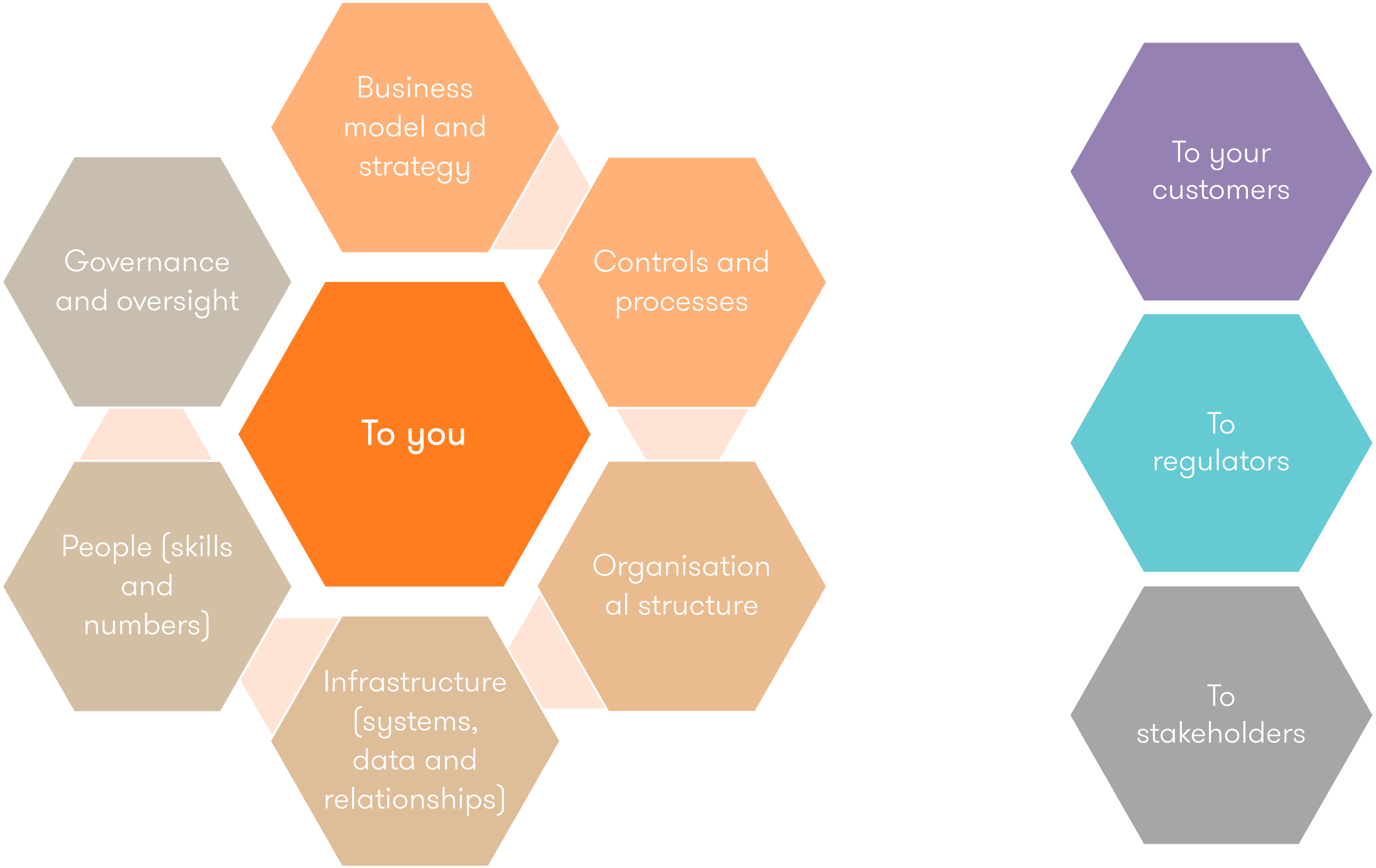
- Project planning
- Resources
- Skill sets
- Technical
- Processes and controls

Business Readiness

- Project management
- Strategy
- Business model
- Controls
- Training

Assurance

Impact assessment



Governance and Oversight

The Basel 3.1 governance requirements are designed to ensure that banks have the necessary systems and controls in place to effectively manage their capital and risk. These requirements include:

Plus, specific IRB model governance and validation requirements

Other critical considerations

Three Lines of Defence

First

- Set risk appetite
- Risk identification
- Controls implementation
- Awareness and training
- Monitoring and reporting

Second

- Policy and framework
- Oversight and guidance
- Assessment and control
- Monitoring and testing
- Reporting (internal and external)
- Training and awareness

Third

- Independent audits
- Compliance assurance
- Remediation follow-up
- Quality assurance

04
Data challenges

Basel 3.1 Implementation data challenges

Basel 3.1 data challenges

Data Availability and Accuracy

Firms must ensure they have access to accurate and reliable data required for regulatory reporting. This includes information on capital, risk exposures, and liquidity. Data must be complete, timely, and consistent to meet the regulatory requirements.

Data Aggregation and Reporting

Basel 3.1 requires firms to aggregate data across various systems and business lines to provide a comprehensive view of their risk profile. This poses challenges in terms of data integration, consolidation, and reporting.

Data Modelling, Analytics and Visualisation

Complex risk models are required to assess capital adequacy and liquidity risk. Validating these models demands advanced statistical techniques and robust back-testing procedures along with an effective visualization of the complex results

Granularity and Granular Data Requirements

Basel 3.1 places an emphasis on granular data, requiring banks to report data at a more detailed level than before. This means banks must collect and report data on a transactional or account level, rather than relying solely on aggregated data.

Data Management and Data Lineage

Basel 3.1 requires firms to establish effective data management frameworks to ensure data quality, traceability, and accountability. Firms must be able to demonstrate the lineage of their reported data, from the source systems through to the final reports.

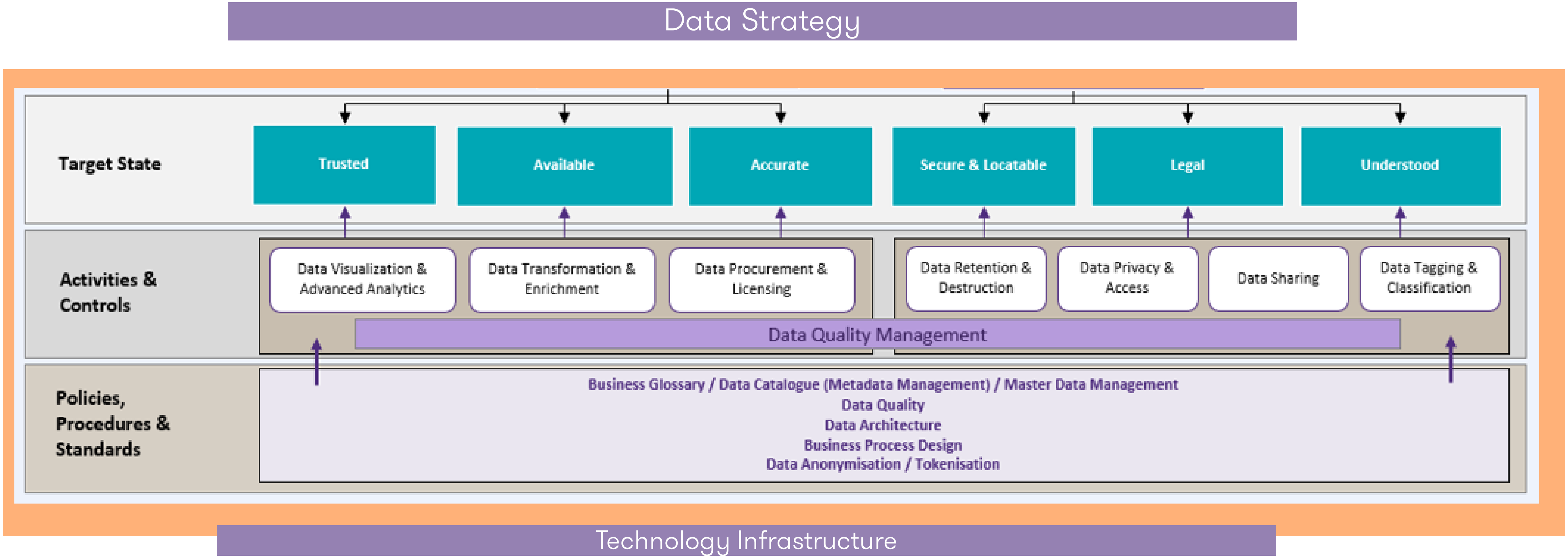
Key Data Principles

- Data Strategy
- Data Management Foundations
- Critical Data Elements & Granular Data Requirements
- Data Governance
- Data Quality

Data Strategy to Deliver Reporting Requirements

Basel 3.1 significantly increases the volume of data required for the regulatory reporting. Firms are required to aggregate data across various systems and business lines to provide a comprehensive view of their risk profile. This poses challenges in terms of data integration, consolidation, and reporting. Firms should define a robust data strategy to enable them to adapt to changing business, market and regulatory needs.

There are Three key aspects to an effective data strategy. A data strategy is underpinned and interlinked with Business Strategy and the existing Technology, Business Process and Polices of the organisation.



Data Foundation to Enable Aggregation and Reporting

Firms must ensure they have access to accurate and reliable data required for regulatory reporting. This includes information on capital, risk exposures, and liquidity. Data must be complete, timely, and consistent to meet the regulatory requirements.

Data Management Foundations blocks need to be in place before an organisation embarks on the regulatory reporting journey.

DATA STRATEGY

DATA OWNERSHIP

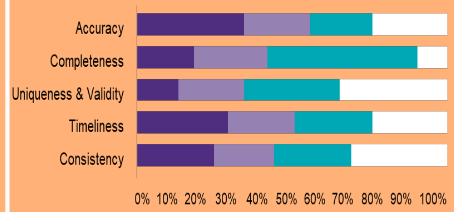
- Accountabilities and RACI
- Data domains by products and businesses
- Data stewards
- Forums
- Policies and standards
- Legal entities/jurisdictions

MASTER DATA MANAGEMENT

- Prioritisation and management of Critical Data Elements (CDE)

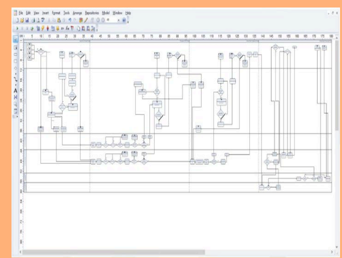
DATA QUALITY

- Data quality rules
- Data quality measures
- Data profiling



DATA TRACEABILITY

- Source to target mapping of data flow
- Identification of control



DATA ARCHITECTURE — Development of authoritative data sources

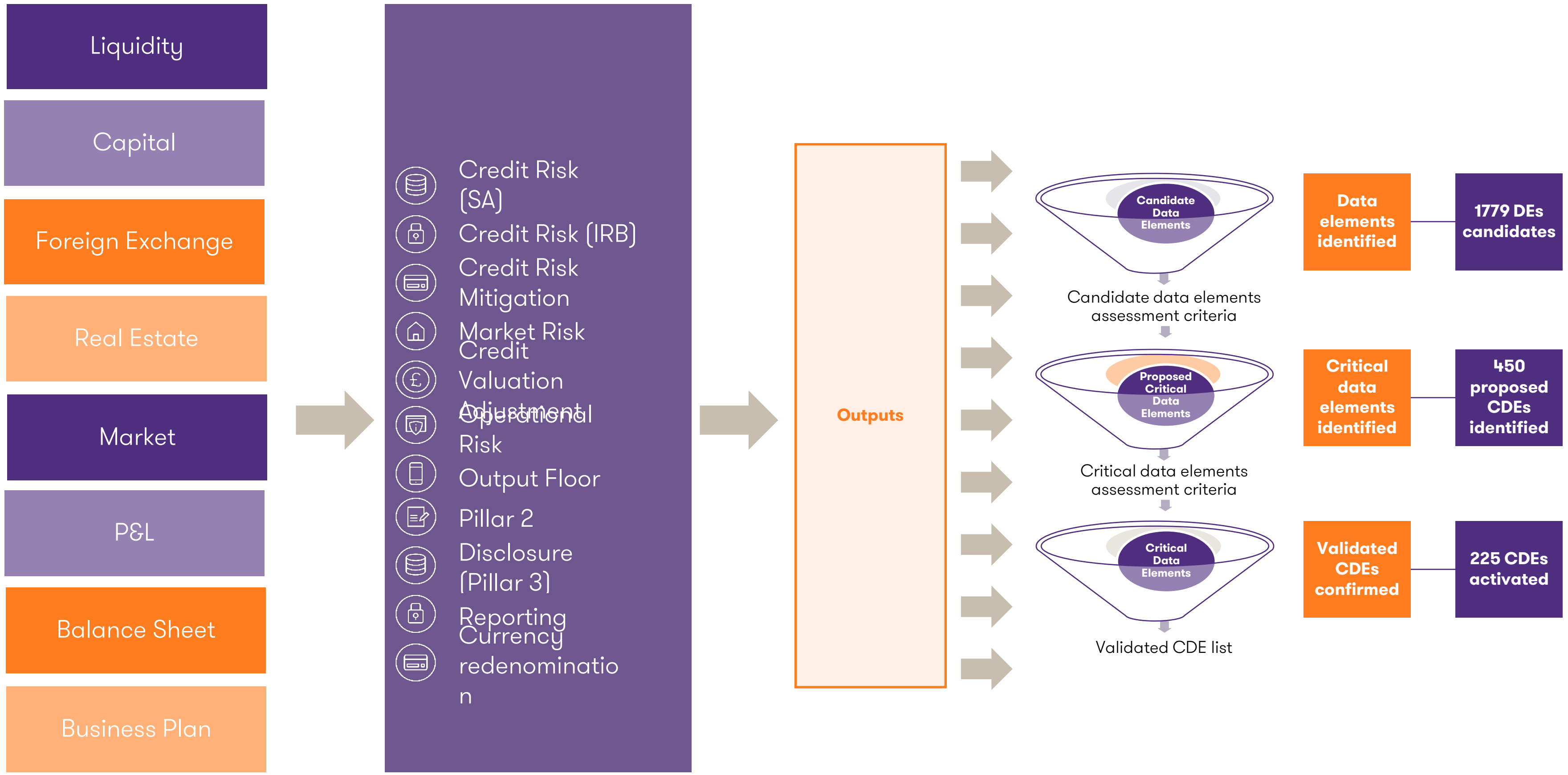
REFERENCE DATA — Organisation wide reference points and industry reference

Data Issues Remediation

Data Execution Plans

Critical Data Elements & Granular Data Requirements

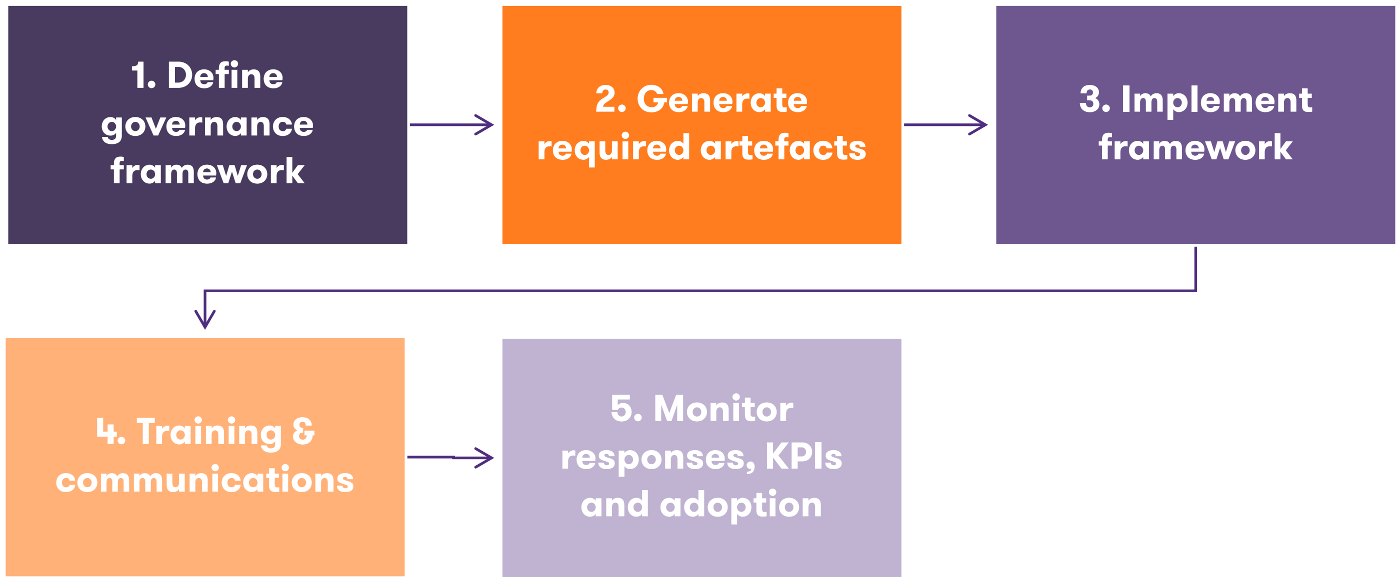
Basel 3.1 places an emphasis on granular data, requiring banks to report data at a more detailed level than before. This means banks must collect and report data on a transactional or account level, rather than relying solely on aggregated data. Firms must identify critical data elements in structured and measured approach to help simplify the reporting process and focus on the key data elements.



Data Governance to Ensure Accountability and Traceability

Basel 3.1 requires firms to establish effective data governance frameworks to ensure traceability, and accountability. Firms must be able to demonstrate the lineage of their reported data, from the source systems through to the final reports.

There are a number of sub capabilities which form part of the overall data governance capability. These areas should be considered when in order to establish an effective data governance vision and develop the overall data governance capability.



Data Quality to Ensure Trust in Data

Basel 3.1 requires firms to establish effective data governance frameworks to ensure data quality, traceability, and accountability. Firms must be able to demonstrate the lineage of their reported data, from the source systems through to the final reports.

There are a number of sub capabilities which form part of the overall data governance capability. These areas should be considered when in order to establish an effective data governance vision and develop the overall data governance capability.

1. Data quality objectives and alignment with data strategy
2. Data quality fundamentals: operating model and supporting processes
3. Defined stakeholder groups, roles and delivery ownership
4. Data quality priorities, development plans and funding
5. Data quality monitoring across dimensions
6. Data quality accessibility and serviceability
7. Data quality reporting
8. Data quality literacy and training

05
Questions

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