Understanding Pillar I Credit Risk Capital Requirements under Basel 3.1/SDDT.

Written by Stuart Fairley

Introduction

Basel 3.1 (referred to as Basel IV in the EU, or Basel Endgame in the US) represents the implementation of the final Basel III reforms, developed following the 2008 global financial crisis. In the UK, these reforms have been crystallising alongside a broader recalibration of the regulatory framework, principally the development of a **Strong and Simple** framework for the smaller, less complex institutions. With the Basel standards written for internationally active institutions, the cost and complexity in complying with these standards is often disproportionate to the level of risk faced by smaller institutions and the objective of the Strong and Simple framework is to reduce the operational burden of such smaller firms whilst retaining the resiliency within the UK financial sector. The first iteration of this simplification has been to ring-fence the least complex firms, referred to as **Small Domestic Deposit Takers** (SDDTs).

In the UK there are c.80 firms that meet the eligibility criteria of an SDDT and, for many of these, the open question facing them has been which of the frameworks (the Basel 3.1 Standardised Approach (SA) framework or the SDDT framework) would be the most appropriate for them. This will be a decision each firm must make individually, weighing up whether the benefit received via operational simplification is justified by any higher capital requirements than they would face under the Basel 3.1 SA approach. Prolonging this question, however, has been the clarity of the requirements under both frameworks.

Timeline

The PRA had originally consulted upon the proposed Basel 3.1 SA requirements in November 2022, via CP16/22. In this consultation paper indicative rules were outlined but subject to industry feedback and challenge during the consultation period. This consultation period closed in March 2023 and resulted in a period of protracted analysis.

In December 2023, the PRA published PS17/23, the near final rules part one, covering the less contentious aspects of Basel 3.1, including the Market Risk, Counterparty Credit Risk and Credit Valuation Adjustment frameworks. In September 2024, the PRA published the near final rules, part two (PS9/24), containing the Credit Risk framework. Concurrently, the PRA have also published CP7/24, the keenly-awaited consultation on the simplified capital regime for SDDTs.

The publication of these two papers enables firms to now make a more considered decision on which framework is preferential. Critically, the PRA have opted to align (largely) the Pillar I capital requirements in both frameworks on the basis that "…the riskiness of an asset is the same regardless of whether it is held by a large or small firm." This will go some way to allay fears that a simplified approach may have offered a computationally simplified yet more conservative calculation, resulting in potentially unpalatable higher capital requirements.

Naturally, an institution's decision will need to consider the impact to their total capital requirement under both frameworks. In addition to the impact of changes to the credit risk Pilar I framework, this will also need to take account of other Pillar I components, such as the add-ons relating to market risk, counterparty credit risk and CVA risk that SDDTs are exempt from holding, along with the impact of the reforms to the Pillar II framework, not discussed as part of this article.

The Basel 3.1 framework is expected to take effect from 1st January 2026 – deferring by another six months from previously planned and twelve months from the originally planned implementation date - whilst the SDDT framework is expected to take effect from 1st January 2027.

For firms that do wish to adopt the SDDT framework, they will need to notify the PRA of their intention – even if this has already been done from a liquidity perspective – and the PRA intend to communicate a six-week window when firms must do this by in due course.

Analysis within this whitepaper

Under the proposed SDDT framework, the PRA have put forward that an SDDT firm calculate their risk weighted assets (RWAs) using the Basel 3.1 SA approach, aligning the two frameworks in this regard. Therefore, the subsequent analysis considers changes to the existing RWA calculations that would apply equally to firms regardless of whether they are looking at either the Basel 3.1 SA or SDDT frameworks.

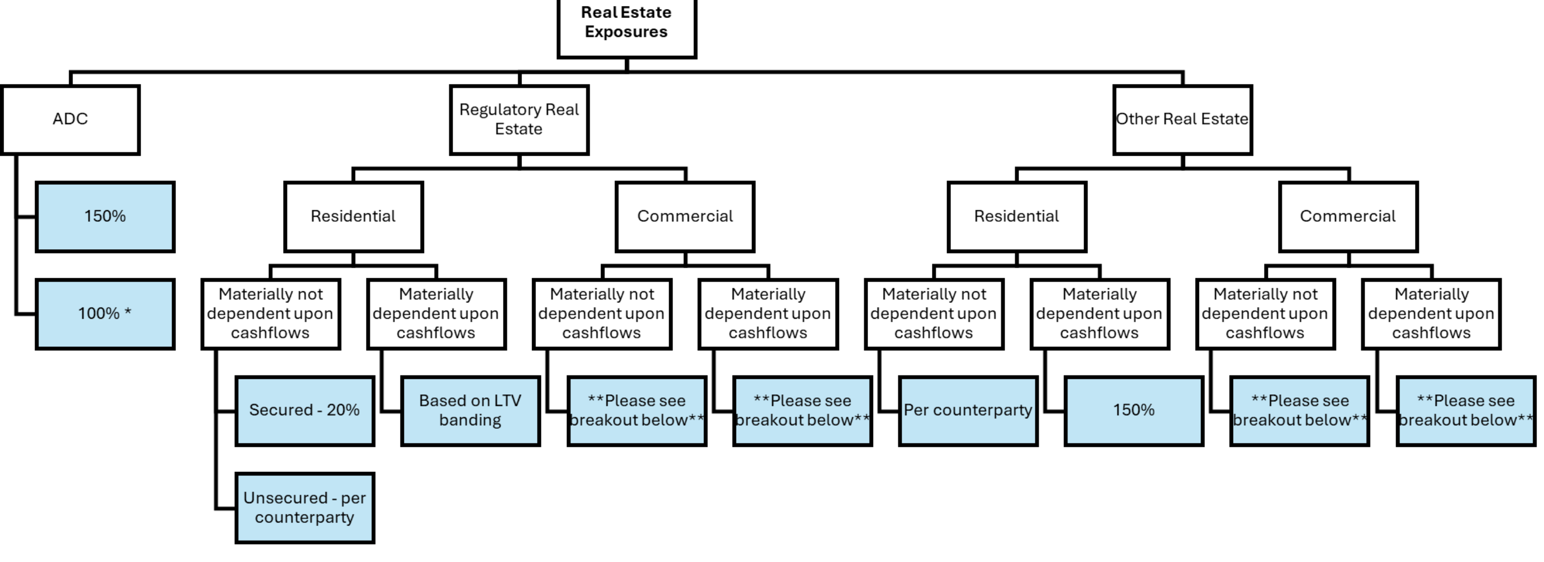
Exposure Classes

Similar to the current requirements, an institution will be required to analyse their on and off-balance sheet exposures into one of seventeen exposure classes. These are largely aligned to the existing exposure classes under the current requirements, with some changes to terminology and to where some specific types of exposures are reported, including:

- •Exposures secured on immovable property are renamed real estate exposures and this exposure class now includes speculative property financing, currently treated as exposures associated with particularly high risk.
- •The exposure class for subordinated debt, equity and other own funds instruments would now include venture capital and private equity exposures, currently treated as exposures associated with particularly high risk. A hierarchy of exposure classes is detailed in Appendix I

Real Estate Exposure

The new exposure class, Real Estate Exposures, brings together the exposure classes 'Secured by Mortgages on Immovable Property' and 'Speculative Immovable Property Financing' classes from the incumbent regulation and is structured accordingly:



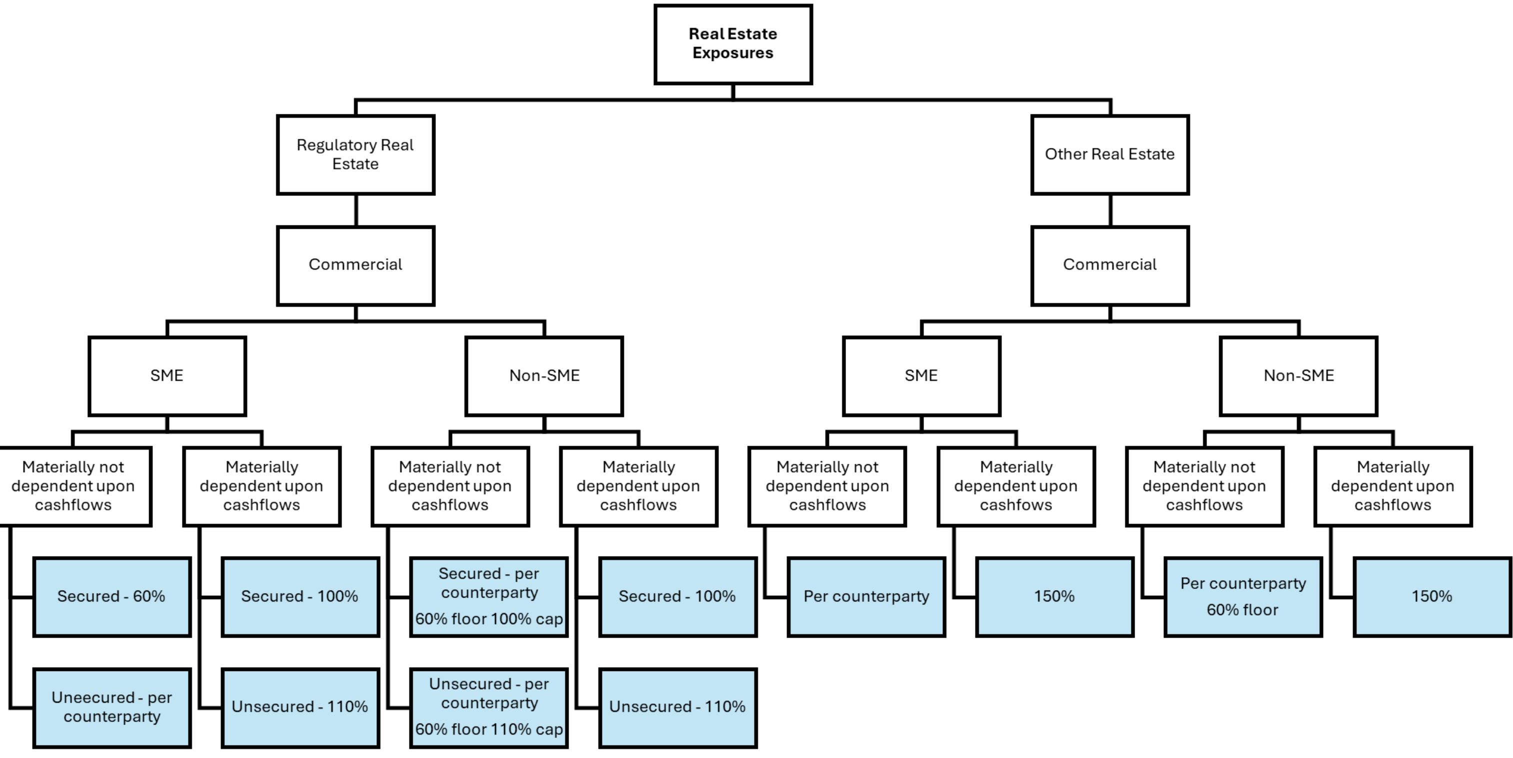
Following the publication of the Basel 3.1 near-final rules, changes include:

- The consultation proposed specific types of property be excluded from classification as residential real estate, including care homes, purpose-built student accommodation and holiday lets. In the near final rules, and following feedback, the PRA have removed this exclusion explicitly but clarified that these types of property can be treated residential real estate only if they are capable of being resold as a standard residential dwelling in the event of a repossession.
- Under the consultation, self-build mortgages, would have fallen into the Other Residential Real Estate classification and would have attracted a significantly higher risk weighting than currently and, in the view of many, disproportionate to actual risk of such lending. Following feedback, the PRA have exempt self-build mortgages from the requirement to be secured by a finished property, allowing them to be risk weighted more appropriately.
- However, for unfinished self-build mortgages, the valuation of the property – for the purposes of determining the loan to value – should be taken as the higher of:
    - 80% of the most recent valuation or;
    - the value of the land.
- For drawn loans, the consultation proposed the appropriate valuation to be used when determining the loan to value of the property should be the value at loan origination, or revaluation following a defined material event.

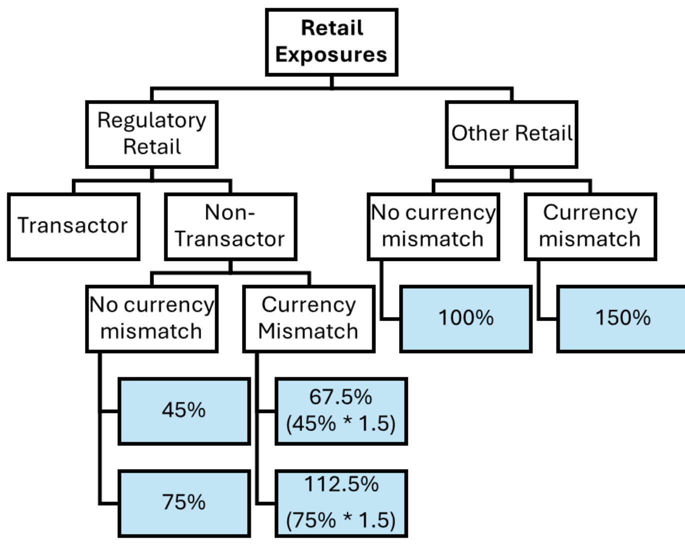
  However, following the consultation the PRA have introduced a 5-year backstop, requiring institutions to obtain an updated valuation after 5 years from the most recent valuation. Where the loan is greater than £2.6m (or 5% of an institution's own funds), this period should be 3 years. There is no expectation from the PRA that the valuation needs to be a physical valuation taking place.
- For broader decreases in market prices, one of the defined events requiring a revaluation, the PRA have clarified this should be where an institution believes the value of the property may have fallen by more than 10% from the most recent valuation.
- There has been a refinement to Residential Regulatory Real Estate materially dependent on cash flows, where the property is greater than 60% LTV and up to 80% LTV. The consultation proposed these exposures would be risk weighted at 45%, however this has been recalibrated as:
    - 40% where the LTV is greater than 60% and less than or equal to 70%;
    - 50% where the LTV is greater than 70% and less or equal to 80%

Break Down of Commercial Real Estate

For Commercial Real Estate, following feedback, the PRA has refined the requirements dependent on whether the counterparty is classed an SME corporate or a non-SME corporate, as illustrated below:



Retail Exposures



- In the original consultation, the PRA had proposed a threshold of £0.88m to qualify as a regulatory retail exposure. The retail exposure value, inclusive of drawn exposures and undrawn commitments, should be assessed against this threshold per individual or groups of connected parties. However, the PRA have revised this to now exclude undrawn commitments for the purposes of determining whether an exposure is eligible for the regulatory retail exposure class.
- Similarly, for drawn exposures, only residential real estate exposures should be excluded when determining the value of exposure, rather than all exposures that do not meet the retail exposure definition.
- The PRA had received several responses against the proposal to remove the support factor adjustment for SMEs but have opted to retain its removal in the near final rules. However, the PRA have recognised the importance of maintaining the UK's competitiveness and growth, will include an 'SME lending adjustment via' Pillar 2A for eligible firms.

Off Balance Items

The below hierarchy shows the conversion factors for various off-balance sheet items. From the original consultation, the PRA have introduced a new 40% conversion factor for other commitments (excluding UK residential mortgages), previously proposed at 50% and bringing the UK's treatment in line with the Basel standards. In addition, 'other transaction-related contingent items' that are not considered credit substitutes now have a 20% conversion factor, down from 50% following challenge from the industry.

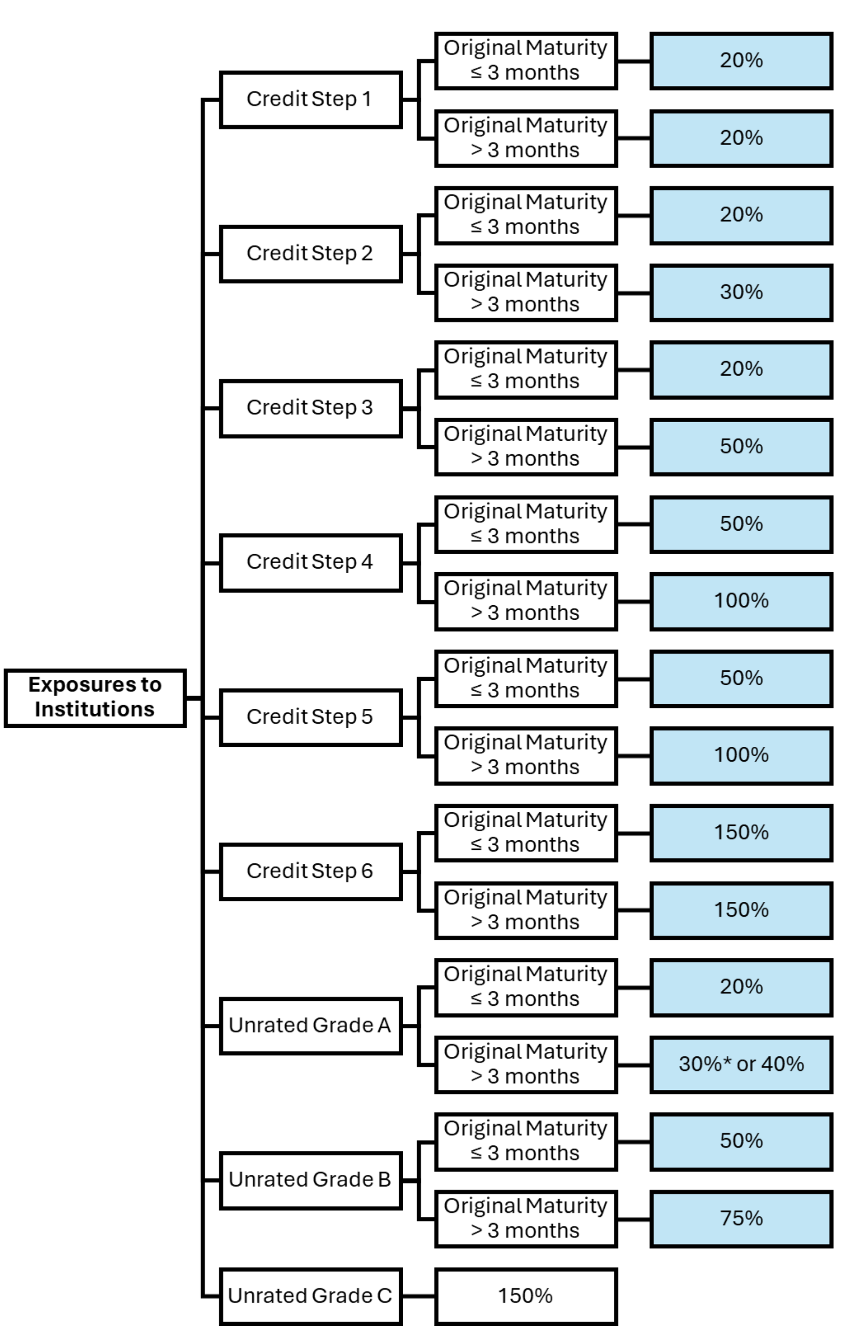
Off Balance sheet items

- 100% conversion factor
  - Issued off balance sheet items
    - Financial guarantees considered credit substitutes
    - Credit derivatives
    - Acceptances
    - Endorsments on bills
    - Irrevocable letters of credit
    - Any other item that has the considered of credit substitutes
- 50% conversion factor
  - Issued off balance sheet items
    - Issued off balance sheet that do not have the character of credit substitutes
  - Commitments
    - **UK residential mortgage commitments**
    - Note issuance facilities and revolving underwriting facilities
- 40% conversion factor
  - Commitments
    - Any ofther commitment not subject to a CF of 10%, 50% or 100%
- 20% conversion factor
  - Issued off balance sheet items
    - Documentatry credits issued
    - Warranties, tender bonds, performance bonds, advance payment guarantees and not conisdered credit substitutes
    - Irrevocable letters of credit not considered credit substitute
    - Shipping guarantees, customs and tax bonds.
- 10% conversion factor
  - Commitments
    - Unconditionally cancellable commitments

Exposures to Institutions

There are three key changes in Basel 3.1 in how exposures to institutions should be treated:

- Under the current rules exposures with a residual maturity of three months or less receive a preferential risk weighting in most cases. In Basel 3.1, this is now based upon the **original maturity**.
- Exposures with an original maturity of more than three months and where the counterparty is credit step 2, should be risk weighted at 30% (currently 50% for exposures with a residual maturity greater than three months).
- Unrated institutions will now require to be assessed as either Grade A, B or C, based upon the perceived credit quality.
- For firms implementing Basel 3.1, there is a requirement to undertake due diligence on their counterparties and apply the higher risk weighting of at least one credit step more where this due diligence gives reason to believe the credit risk of the exposure is higher than the counterparty's external credit rating would indicate. This due diligence is not required to be performed by SDDT firms.

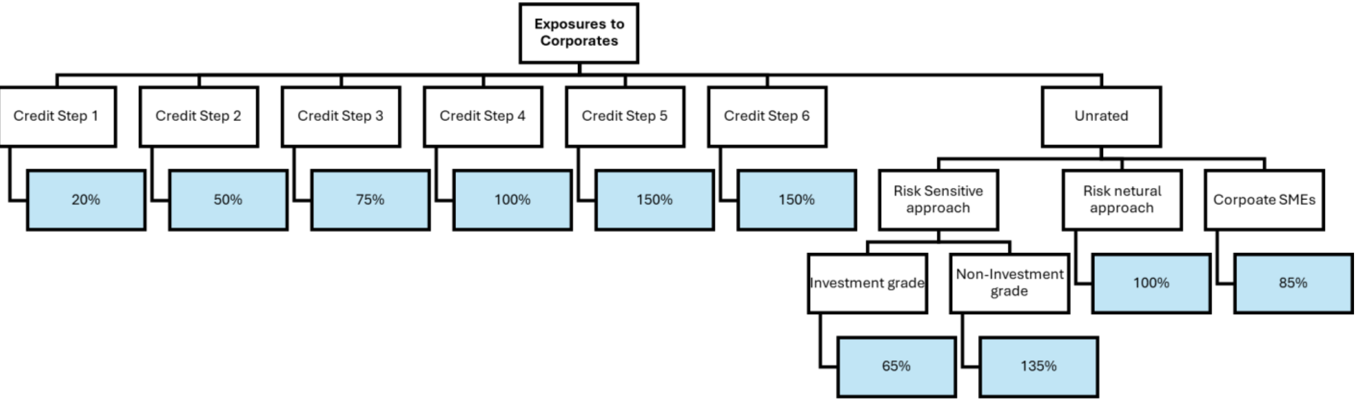


* Where the CET1 ratio ≥ 14% & Leverage Ratio ≥ 5%.

Exposures to Corporates

Within Basel 3.1 rules a new exposure sub-class has been introduced for Corporate SME exposures not eligible for the Retail exposure class.

For unrated exposures institutions can apply to the PRA to adopt a risk sensitive approach to such exposures which, if granted, would enable lower risk weighting for unrated exposures assessed as investment grade. For institutions not going down the risk sensitive approach, exposures would be risk weighted under the alternative risk neutral approach.

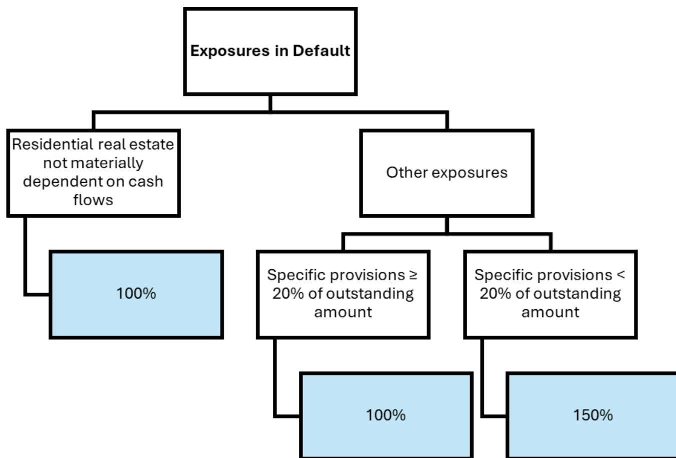


There were no material changes in the near final rules to the proposals in the original consultation.

Exposures in Default

Under Basel 3.1 rules, the proportion of specific provisions will now be assessed against the **outstanding amount** of the exposure, rather than the unsecured portion.

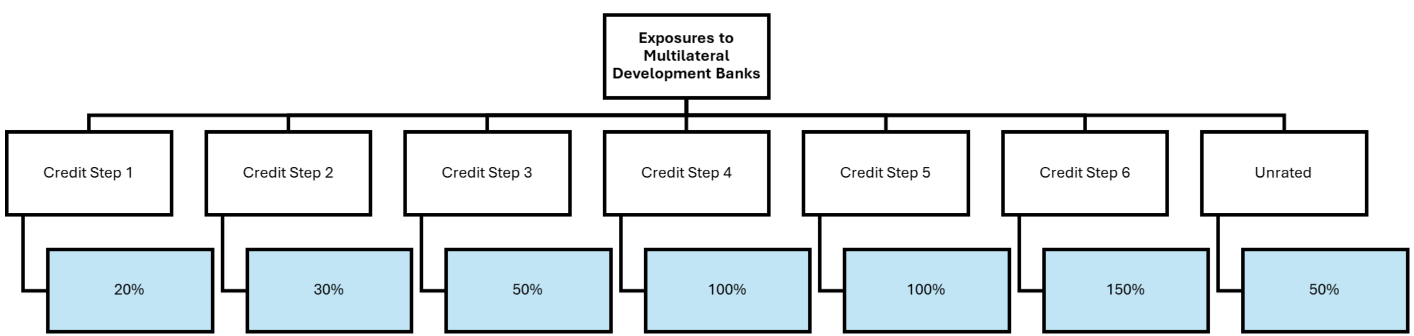
The PRA have **not** exercised an option, available at national discretion, to allow a 50% risk weighting for defaulted exposures where the specific provision is greater than or equal to 50% of the outstanding amount of the loan.



There were no material changes in the near final rules to the proposals in the original consultation.

Exposures to Multilateral Development Banks (MDBs)

Many exposures to multilateral development banks are risk weighted at 0%, however, for banks not listed under Article 117, para. 2 of the CRR, are currently treated as exposure to institutions. In Basel, 3.1 risk weights are prescribed for such non-0% eligible MDBs. These are aligned to the corresponding risk weightings for institutions, for original maturities greater than three months except for unrated MDBs, that should be risk weighted at 50%.



There were no material changes in the near final rules to the proposals in the original consultation other than the PRA have now amended the requirement such that MDBs attracting a 0% risk weighting are now exempt from the due diligence requirements under Basel 3.1.

Other Changes of Note

- The PRA have introduced a definition of 'SME' based on the annual turnover calculated at the highest consolidated accounts of the group and that is expected to increase the number of firms eligible to be deemed an SME.
- Clarification has also been given on how to treat exposures collateralised by multiple types of property collateral, where these should be proportionally segregated into the different exposure classes, relative to the types of collateral.
- There has been a refinement (simplification) to the definitions of 'materially dependent on cashflows generated by the property' to make this easier for firms to assess. A real estate exposure must be treated as materially dependent on cashflows, unless one of the below criteria is met:
  - The exposure is secured on the borrower's home residence.
  - The borrower is not a 'professional landlord' – the three-property rule.
  - The exposures are to social housing companies.
  - An exposure to an association or similar that exists to grant members the use of a primary residence in the property securing the loans.
- Unrated central banks can now be risk weighted on the corresponding risk weight assigned to the central government of the country.

Conclusion

Both the final reforms to Basel III and the introduction of the simplified framework under the Strong & Simple regime represent major milestones in the UK regulatory landscape. The recalibration of the capital requirements are purported to better reflect the truer, underlying risk of such undertakings and this should give comfort to institutions, regulators and the country around the resiliency of the UK Financial sector.

Within Pillar I, the revision to the credit risk rules will represent a material change in how firms are calculating their minimal capital requirement. Whilst mathematically, there is nothing overtly complex to these changes, there will be the requirement on firms to ensure they can efficiently source the appropriate data in order to assess and assign their exposures into the more granular classifications represented in the rules and this will apply to firms regardless of whether they adopt Basel 3.1 or the SDDT capital regime.

For firms eligible for the SDDT capital regime, they should be reviewing the consultation paper and other sources to better understand the implications to their institutions under the proposals to help inform their decision on whether the SDDT capital regime is appropriate for them. Naturally, this is in a consultation phase and the proposal is subject to refinement and therefore may not be a full representation the final framework, however firms are not yet required to make a formal decision on whether to apply for the SDDT modification until a future window still to be disclosed by the PRA. This will be before 31st December 2025, with the interim capital regime (effectively remaining under the existing capital/reporting) requirements commencing from the 1st January 2026.

For firms who intend to adopt the Basel 3.1 SA approach, then they should be planning for the implementation of the new requirements from the 1st January 2026. This should include identifying all data requirements and assessments required and ensuring that, operationally, this information is captured and easily accessible ahead of the transition. Institutions should also be familiarising themselves with the changes to the regulatory reporting templates, in addition to the changes to the underlying capital calculations.

Appendix I: Hierarchy of Exposure Classes

- **Exposure classes**
  - Exposures to central governmanents or central banks
  - Exposures to regional governments or local authorities
  - Exposures to public sector entities
  - Exposures to multilateral development banks
  - Exposures to international organisations
  - Exposures to institition s
  - Exposures to corporates
  - Retail exposures
  - Real Estate Exposures
  - Exposures in default
  - Exposures wassociated with particularly high risk
  - Exposures in the form of covered bonds
  - Exposures representing securitisation positions
  - Exposures to institutions and corporate with a short term credit assessment
  - Exposuyres in the form of unit shares or CIUs
  - Subordinated debit, equity and other own funds instruments
  - Other items

About the Author

Stuart has 15 years of experience working in Finance and Treasury roles within financial services. Stuart was previously the principal ALMIS user at the Scottish Building Society prior to joining the company and now supports clients and end-users to gain maximum value.

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ALMIS Head of Client Experience

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