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Basel 3.1 – Implications for the Real Estate Finance Market

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On 30 September 2022, the Prudential Regulation Authority (the "PRA") published Consultation Paper 16/22 (the "Consultation Paper") proposing for the **implementation of Basel 3.1 standards in the UK**. The consultation closes on 31 March 2023, with the proposed implementation date beginning 1 January 2025 (with a transition period of five years from that date for most provisions).

This article sets out a summary of the key changes of interest to those in the real estate finance ("REF") market.

Background

The Basel 3.1 standards were published by the Basel Committee on Banking Supervision ("BCBS") on 7 December 2017, with an original implementation date of 1 January 2022 delayed due to COVID-19.

The Basel 3.1 standards are the parts of the Basel III standards that remain to be implemented in the UK. The Basel III standards that have been implemented in the UK have primarily focused on increasing the quantity and quality of capital maintained by firms (*i.e.*, the numerator of capital ratios) and also introduced new requirements for leverage and liquidity.

Concerned that downward movement in average risk weights (measured by the ratio of risk-weighted assets ("RWAs") to assets) over the last 10 years is due to fairly pervasive underestimation in internally-modelled risk, the PRA is proposing to align with international standards and implement the final Basel III package of significant changes to the way firms calculate RWAs. The PRA's aim is to mitigate the threats to confidence caused by degrees of variability in calculation of risk weights and resultant inconsistencies in capital ratios and difficulties in comparing like-for-like.

The proposals in the Consultation Paper address mainly the final element of the Basel III standards – the measurement of RWAs (*i.e.*, the denominator of capital ratios). The proposals would, among other things, revise the calculation of RWAs by improving both the measurement of risk in internal models ("IMs") and standardised approaches ("SAs"), and the comparability of risk measurements across firms.

Summary of Key Changes

General

Basel 3.1 standards include revised standard and internal ratings-based approaches for credit risk, revisions to the use of credit risk mitigation techniques, a revised approach to market risk, the removal of the use of internal models for operational risk capital requirements and for credit valuation adjustment and their replacement with new standard and basic approaches, and the introduction of an aggregate "output floor" to ensure that total RWAs using internal models cannot fall below 72.5% of RWAs derived under standard approaches.

This means a more granular set of standard approaches for assessing risk exposures and the removal of some internal model approaches, as well a new modelling approach for internal ratings-based assessments, alongside improvements to the trading book/non-trading book boundary.

Real Estate Loans under Credit Risk Standardised Approach

The Consultation Paper proposes changes in respect of the treatment of real estate loans (either secured on commercial property or on residential property). The overall intended effect of these changes would be to bring SA RWAs for real estate lending closer to those under the internal ratings-based approach ("IRB"), particularly for low-risk residential mortgages, while introducing new requirements to help ensure RWAs for real estate exposures are appropriate.

In summary, real estate loans would be divided into two categories, namely:

1. "regulatory real estate exposure" which meet six specific conditions that are consistent with the relevant Basel criteria (namely: (i) it is finished; (ii) there is legal certainty on claims over the property; (iii) the exposure is secured by a first charge over the property; (iv) an assessment is made on the ability of the borrower to repay; (v) it is prudently valued; and (vi) adequate documentation is maintained); and
2. "other real estate" in cases where these requirements are not met.

Each of these categories would in turn include different sub-categories distinguishing between loans secured on residential real estate and loans secured on commercial real estate.

For regulatory real estate loans, a loan-splitting approach would apply whereby real estate loans with a loan-to-value ("LTV") ratio below a certain level receive a lower risk weight with any excess above that level being subject to a higher risk weight. This means that for these loans, the prudent valuation of the collateral securing the loan would become increasingly important given the proposed key role of LTV to calculate the applicable SA risk weight.

For other real estate loans, the proposed approach is closer to the current one – but with revisions.

Conclusion

Our regulatory specialists are currently working with the Commercial Real Estate Finance Council ("CREFC") Europe on industry feedback to the Consultation Paper.

Please feel free to get in touch with the Cadwalader team to discuss the contents of this update. We will provide further updates on this topic in due course.

*This article was also published in Cadwalader's "**Cabinet News and Views**" newsletter.*