UK FINANCE

A response to

PRA CP16/22

Chapter 4 - Credit Risk – internal ratings-based approach

March 2023

Introduction

UK Finance is the collective voice for the banking and finance industry. Representing more than 250 firms, we act to enhance competitiveness, support customers, and facilitate innovation.

We are pleased to respond to chapter 4 of the PRA's CP16/22 which proposes changes to the PRA's approach to implementing the Internal Rating Based (IRB) arising from the finalised Basel 3 standards ('Basel 3.1')

Please find below answers to the questions in the CP. We would be pleased to have further discussions with the PRA on the issues highlighted below but generally support the PRA's proposed implementation of the finalised Basel standards in the UK.

Response to questions

As a general comment to the introduction of the new Credit Risk: Internal Ratings Based Approach (CRR) Part of the PRA Rulebook relating to the IRB approach, to replace CRR articles and associated technical standards, the members welcome the simplification of regulations, although would welcome clarification on the expected level of yearly attestation process. Currently majority of the IRB rating systems are attested against the CRR and preparing to attest to the various EBA guidelines referred to in the existing SS11/13. The required continuous effort for attesting to these regulatory requirements on an ongoing basis can be onerous for portfolios where the models and the environment is not changing year on year. We would propose to set expectations around the attestation process potentially on a risk-based basis or setting the periods to less than a year cycle below a certain materiality threshold.

Question 16: Do you have any comments on the PRA's proposed implementation timelines?

Recommendation 4.1

- Where relevant firms should be able to submit models ahead of the July 2024 commencement date of model submission.

- An article 146 like risk-based approach to model review should be adopted.

Rationale

We welcome the delay by the PRA of IRB roadmap submission deadlines for models that are most likely to be affected by the implementation of Basel 3.1. This will reduce duplication the reduce the burden on firms and the PRA.

We would like to understand the PRA's expectations regarding approval timelines given the 1 January 2025 implementation date. Many models have already been redeveloped to meet the requirements of IRB Repair.

For international banking groups, coordination of the adoption of new models under Basel 3.1 is imperative. Some LGD and EAD models have already submitted by some firms to local regulators. It would be ideal if all new models are approved and implemented in all relevant jurisdictions simultaneously, meeting the 'use' test globally.

Proposal

Where overseas models are being updated to align to other regulators' Basel 3.1 implementation timelines, confirmation that Overseas Models Approach applications can be submitted before 1 July 2024 and will be reviewed in a reasonable timeframe to enable a coordinated implementation for both consolidated and local reporting.

Where model implementation is expected to follow quickly after 1 January 2025, a simple approach to Article 146 could be taken, starting with the Post Model Adjustments ('PMA') as agreed for IRB Repair, and updated where appropriate to comply with the 'near-final' policy statement.

Question 17: Do you have any comments on the PRA's proposals for permission to use the IRB approach?

Recommendation 4.2

- The PRA should affirm that compliance attestations need not be made by a Senior Management Function
- Firms should be permitted to confirm model changes remain compliant rather than resubmitting a full refreshed self-assessment
- The PRA should confirm the 'Material compliance thresholds should apply immediately following the publication of the final rules

Rationale

Attestation

It is not clear whether the attestation of compliance when applying to make material changes as per Para. 4.40, is required to come from the Senior Management Function (SMF). Under the current process, new model and material change applications are submitted through a routine process with an appropriate senior manager (not an SMF) providing the attestation of compliance with regulations). Only changes to the IRB permission require an SMF approval. A relevant model approval authority could be allowed to provide the attestation of compliance.

The proposal to align documentation requirements for all model changes is unduly burdensome for non-material model changes. A more proportionate approach should be applied, confirming the changes remain compliant, but without any need to resubmit a full refreshed self-assessment, nor to resubmit full model documentation.

Material compliance

We would welcome clarification of what compliance threshold the PRA will apply between publication of the final rules and the Basel 3.1 implementation date of 1 January 2025. We would propose applying the 'material compliance' threshold immediately following publication of the final rules, to provide clarity for firms with IRB applications in train over that period.

Question 18: Do you have any comments on the PRA's proposed IRB exposure classes and sub-classes?

Recommendation 4.3

- The PRA should clarify treatment for certain types of government sponsored enterprises such as FMNA and FMCC (Fannie Mae/Freddie Mac).

Rationale

Fannie Mae and Freddie Mac. are currently subject to the IRB approach and are classified as corporate exposures. Members seek clarification of their treatment under Basel 3.1. Classification as central government was considered due to the current conservatorship of these entities by the US government. However, the corporate exposure classification is considered the most appropriate as the entities do not benefit from an unconditional or explicit guarantee by the US government. We consider these exposures low risk as they are supported by the underlying mortgages an implicit guarantee by the US government. Currently the US capital rules classify both entities in a separate category, 'government sponsored enterprise' and are assigned a risk-weight of 20%. The PRA should consider the risk profile of exposures to certain entities such as these, taking account of factors, such as the type of assets supporting the exposures, as well as any conditional or implicit guarantee by a sovereign government.

Proposal

Government sponsored entities such as Freddie and Fannie Mae should not be classified as corporates and should instead be classified as PSEs and/or quasi sovereigns and moved to the standardised approach.

Quasi sovereign – Public Sector Entity Export Credit Agencies (PSE-ECAs)

Recommendation 4.4

- ECAs, which would fall into a category of public sector entities ('PSE-ECA'), should be treated as central government and central bank category where there is no difference in risk between the central government and the PSE-ECA.

Rationale

We are requesting that the PRA avails itself of the Basel discretion under CRE 20.12[1] to allow certain quasi sovereigns (i.e. those ECAs classed as PSEs) to be treated as sovereigns under the proposed mandatory standardised approach (SA). This would enable direct access for this non-significant class of quasi sovereigns to be treated as sovereigns as per Basel, which also provides for similar treatment to be applied to non-UK exposures where other jurisdictions are also using this Basel discretion.

The UK proposed mandatory standardised approach for sovereigns under CP16/22 allows direct access to a zero-risk weight for ECAs classed as sovereigns. However, those classed as quasi-sovereigns (i.e. PSE-ECAs) will not be able to directly access the same treatment under the proposals (CP16/22, 3.66[2]).

The request to the PRA relates to considerations around equivalence, and the PRA removal of UK CRR 116(4). While UK CRR Article 116(4) currently reflects, in part, the discretion set out in Basel 20.12 for the UK, it does not include the ability also set out in the Basel for firms to treat non-UK PSE exposures as sovereign where these third countries also allow the PSEs in that jurisdiction to be risk-weighted in the same manner.

Proposal

- (1) UK-designated list for eligible global PSE-ECAs mandated to be treated as central government and central bank, or
- (2) PSE-ECAs' direct access through Article 116 to treatment as a central government and central bank under Article 114 conditions

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[1] ***Basel CRE20.12***: *Subject to national discretion, exposures to certain domestic PSEs[7] may also be treated as exposures to the sovereigns in whose jurisdictions the PSEs are established. Where this discretion is exercised, other national supervisors may allow their banks to risk-weight exposures to such PSEs in the same manner.*

[2] ***CP16/22, 3.66:*** *For PSEs, the PRA proposes not to treat any exposures to UK PSEs as exposures to the UK central government, a regional government, or a local authority in the UK. This aligns with the Basel 3.1 standards, as the PRA proposes to not implement the Basel 3.1 [ie Final Basel 3] national discretion to treat PSEs as exposures to the sovereign in certain circumstances.*

PSE-specific equivalence framework

Recommendation 4.5

- A UK designated list of ECAs should be established.

Rationale

We would welcome a UK designated list for eligible global PSE-ECAs via a PSE-specific equivalence framework under HMT remit, or a standalone-assessment and framework devolved to the PRA. Alternatively, given this is small and less material subset of exposures, a preferred operational fix may be achieved via a new clause in Article 116 to cover this subset to potentially access zero RW treatment under the CRR 114 standardised routes, and rely on the 'supervisory and regulatory arrangements' equivalence requirements for non-UK exposures under 114(7) conditions.

Potential drafting to address enable application of the same consistent treatment for sovereign ECAs and quasi-sovereign ECAs given no difference in risk and national discretion under Basel:

> *[Article 116 insert:] Exposures to public-sector entities may be treated under Article 114 as exposures to the central government and central bank in whose jurisdiction they are established where there is no difference in risk between such exposures because of the existence of specific public arrangements.*
>
> *[Article 147A(1)(a) insert:] In addition, for point (b)(i) of Article 147(2), exposures of a quasi-sovereign institutions classed as a public sector entity under Article 116 where there is the existence of specific public arrangements and no difference in risk between such exposures and those by the central government and central bank.*

Proposal:

(1) UK-designated list for eligible global PSE-ECAs mandated to be treated as central government and central bank, or
(2) PSE-ECAs' direct access through Article 116 to treatment as a central government and central bank under Article 114 conditions

Operational consideration around indirect access

The PRA confirmed in industry discussions the expectation that banks can indirectly apply a zero-risk weight using the credit risk mitigation framework given the allowance for indirect counter-guarantees by sovereign entities (CP6/22, 5.101; Appendix 4, Article 214). This means that instead of applying unfunded credit protection (UFCP) conditions to a PSE-ECA issued guarantee in respect of the transaction, the bank will look through to the public arrangements/guarantee for the PSE-ECA. While in theory, we agree that this may achieve the same treatment indirectly for many export finance exposures in the form of cover/guarantees, it adds some complexity, uncertainty and potential compliance, operational and legal costs. In addition, in the separate potential business scenario, for example, where a bank is lending to a PSE-ECA and UFCP is not in use then there remains no direct or indirect access.

Given ECA exposures – due to an organisational/institutional structural difference – can be designated in either the sovereigns or quasi sovereigns classes, we believe this access should be direct and automatic for PSE-ECAs given the proposed application of a mandatory standardised approach for government ECAs with the same risks.

International competitiveness analysis

It is important to maintain an equivalence with EU and other jurisdictions where the financial institutions (banks) can treat exposures to PSE as central government when such PSE benefits from the central government financial support. For example, where the central government will assume the entire liability of the PSE-ECA in the event of insolvency and such arrangement is confirmed in their relevant national legislation.

Some official ECAs from certain jurisdictions (Denmark, Switzerland, Belgium, US, Korea, Japan etc) take an organisational or institutional form of a PSE as opposed to being an integral part of central government itself. EEA banks may treat the PSE-type of ECA exposures (typically an 'unfunded guarantee') as a central government exposure as these PSEs have financial support from the central government under the specific legislative arrangement as per CRR 116(4) and/or CRR 150(1)(d)(i).

It is important to point out that, in the ECA business, UK banks globally compete with non-UK banks in pricing the non-UK PSE's exposures, not on the pricing of UK-PSE exposure.
The PRA proposed Article 116(3A), corresponding to the UK CRR 116(5) equivalence regime, leads to a 20% RW at best (Credit Quality Step 1) for non-UK PSEs. As such, UK banks will not be able to compete with, for instance, EEA banks which may apply 0% RW for exposures to PSE ECAs who are treated as central government. This, as in most EU member states, the competent authorities chose to allow the direct use of the SA. UK banks will be disadvantaged compared to banks in the EU or other jurisdictions in running a global ECA business. UK banks will be uncompetitive in this segment (PSE type) of ECA exposure.

Pre-Brexit: IRB banks were able to access SA and the zero RW via the EU CRR Article 150(1) for, at least, EEA ECA exposures under Article 114(4) and 116(4). However, this access was removed post Brexit given restriction of Article 114(4) and 116(4) to the UK. Some firms had previously engaged with authorities on a bilateral basis regarding the Brexit-related impact for EEA sovereigns[3] and, in particular, ECAs.

UK Basel 3.1 proposal on PPU: The PRA proposes to remove Article 150(1)(d)[4] given the introduction of a new PPU framework for application of the SA for IRB banks for certain asset classes (ex quasi sovereigns), and mandatory standardised for sovereigns.

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[3] Loss of 0% treatment from Temporary Transition Period (TTP) end (where access is via UK CRR Article 150 to standardised approach) for EEA sovereigns.

[4] *CP 16/22 4.106: The PRA has also considered whether to retain other existing CRR permanent partial use exemptions. The PRA considers that the majority of the existing exemptions are either no longer relevant, due to other changes in the framework such as restrictions on the scope of modelling; or no longer necessary, due to the proposed introduction of a more general exemption for immateriality as set out in (b) above. The PRA therefore proposes to remove these exemptions. The PRA proposes; however, to retain the exemptions currently in the CRR relating to intragroup exposures and exposures in the form of minimum reserves required by the Bank of England.*

Proposal

To allow quasi sovereigns (e.g. those ECAs classed as PSEs) to be treated as sovereigns under the proposed mandatory standardised approach (SA).

Large Corporates

Recommendation 4.6

- The definition of large corporates should be better aligned with Basel standards to ensure consistency of application globally.
- The PRA should provide about the classification and modelling treatment of entities that are part of group

Rationale

The definition of large corporates diverges from the definition in Basel CRE 30.34 to 35. This will cause consistency issues for globally active banks as it could result in corporates not being consistently classified as large corporates depending on local regulatory implementation.

The proposed currency redenomination from Euros to Sterling will cause consistency issues within international bank groups when there are currency fluctuations. For example, the large corporate €500 million threshold for 'total consolidated annual revenues' being redenominated to greater than £440 million could result in a different population scope for AIRB modelling and regulatory reporting across different regulators.

In addition, for the definition of 'large corporate' the PRA proposes to adopt only the 'three year rolling average turnover' measure and not also the most recent turnover amount every three years included in the Basel text. This is inconsistent with other jurisdiction's proposed implementation of the Basel text and could be a source of inconsistency for international banks. Both definitions should be available to be consistent with Basel.

The Basel text states the turnover used is based on the accounting standard applicable to the ultimate parent of the group and it should be from the audited financial statements. This is not however specified in proposed Article 147(4E)(b). The use of an in-house aggregate turnover used by the bank for risk management purposes for groups of corporates would be helpful as an alternate measure to be used where there are no audited consolidated accounts available.

The consultation does not provide clarity for the following scenarios:

- Will an SME with turnover less than £440mn but belonging to a group with total annual turnover greater than £440mn be classified as Large Corporate exposure sub-class and therefore treated under FIRB?
- Will a Finance company with turnover less than £440mn but belonging to a group with total annual turnover greater than £440mn be classified as Large Corporate exposure sub-class and therefore treated under FIRB?

Proposal

We recommend that the BCBS Euro threshold should be permitted in the UK as an alternative to the sterling figure for as an alternative to aid banks who are active across Europe. In relation to the turnover measure, we proposed that the most recent turnover every 3 years is permitted as an alternative to three year rolling average, and the PRA clarifies that in-house aggregate turnover, used for internal risk management purposes, can also be used for the determination of a 'large corporate'.

From a PD modelling perspective tan SME or Finance company belong to a group with total annual turnover more than £440mn should be modelled under the same ranking model. This this would make intuitive sense, i.e. to rate an SME for example using the same ranking model as an entity that has a turnover higher than £440m.

Financial corporates

Recommendation 4.7

- The definition of financial corporate should be broadened to include other types of financial institutions such as funds.

Rationale

In Article147(4E) para (b), financial corporates are defined as 'financial sector entities' (FSEs). It is unclear whether this is intentional. The term FSEs is referenced in many places in the proposed regulation, such as the AVC for RWA calculation, while the term Financial Corporates is only used to define the scope of AIRB modelling. This definition will cover a wider set of exposures than is envisaged by Basel e.g. ancillary services undertaking

As set out in our response to question 19, we believe that Basel intended to include a broader population of financial corporates than 'FSE' when restricting the availability of the AIRB approach and we observe other jurisdictions align to the Basel definition which causes consistency issues for different population scopes for AIRB modelling and regulatory reporting for different regulators. This should include other types of entity in addition to FSEs, when restricting the availability of the Advanced IRB approach to 'financial corporates', and which have similar low-default nature. For example financial corporates should include funds, which under current EBA guidance are out of scope of the FSE definition. We believe the PRA should reconsider the definition of financial corporates.

Proposal

Financial corporates should not be defined as FSEs but should be aligned to the Basel definition and should include Funds.

Retail

Recommendation 4.8

- The PRA should:
  - restrict the retail SME limit to only drawn exposure amounts
  - increase the threshold
  - consider an alternative Euro threshold.

Rationale

The provision of additional, undrawn, facilities is vital to serving customers' needs. However the inclusion of undrawn limits in the assessment against the Retail SME limit will push many customers into a different regulatory definition, with potentially higher capital charges and costs, resulting in a further reduction in customers falling within the Retail SME threshold. This should not be amended now but should be combined with a review of the exposure threshold which has remained unchanged in Basel since 2004. From a strategic perspective, the Retail SME limit has not been updated by Basel for many years, and no longer reflects the reality of these exposures. The banking population which benefits from the Retail SME threshold has reduced since the definitions were first introduced. Within the UK, obtaining audited accounts for an SME has become progressively more difficult. For comparison, the Companies House requirement is now for audit at a turnover of £10.2 million (raised from £6.5 million in 2016) / assets worth more than £5.1 million (raised from £3.26 million in 2016). An additional test of 50 employees or fewer was added in 2012 (needing to meet any two of the three criteria).

The Currency Redenomination requirements for the 'retail' exposure class, to reflect the €1 million threshold stated in the Basel 3.1 standard to £0.88 million will cause consistency issues within an international bank group if there are currency fluctuations. For example, one categorisation within France, but a different categorisation in group reporting is operationally challenging to implement.

In Article 147(5)(a)(ii), additional clarification has been provided for the definition of the Retail exposure class regarding consideration of "notional values of undrawn commitments" when comparing the "total exposures" against the GBP 0.88 million threshold. This additional clarification should also be provided in Article 147(5A)(c) for the definition of QRRE to avoid ambiguity, in particular what amounts should be considered when comparing against the GBP 90,000 threshold, and the level of aggregation when considering "maximum exposure" (i.e., clarification of whether maximum exposure should be interpreted as total exposure across all relevant facilities, or maximum individual exposure across all relevant facilities).

Proposal

The PRA should reconsider the inclusion of undrawn commitments in the assessment against the Retail SME limit, consider raising the Retail SME limit from the proposed GBP 0.88 million and allowing for this to be expressed in Euro as an alternative to thew GBP figure to aid banks who are active across Europe. Clarification of QRRE definition should also be provided.

Specialised lending

Recommendation 4.9

- The PRA should incorporate the full specialised lending definition in Basel CRE 30.07 into Article 147(4D).

Rationale

The current definition in UK CRR 147(8) and proposed definition in draft PRA rulebook 147(4D) can lead to inconsistency across banks in classification of exposures as either specialised lending or corporate, depending on interpretation and/or different financing structures. Some financing structures for aircraft and shipping will not meet all four criteria that must be met in legal form or economic substance. For example, such structures where banks also have recourse to the corporate obligors or lessees.

Question 19: Do you have any comments on the PRA's proposed restrictions on the use of the IRB approach?

Central Governments and central banks

Recommendation 4.10

- the PRA should allow internally used sovereign models as input into other models such as for corporate rating systems

Rationale

Removal of IRB for central government and central bank exposures may require further changes to be made to institution and corporate rating systems when the central government rating is an input. It is not clear as to whether the use of an unapproved model to generate the ceiling would be permitted. Use of an external model (being the use of external rating agencies views of governments) would be counter to the requirement for the firm to undertake its own assessment. Either approach will require firms to submit changes for PRA approval/notification, depending on the materiality of the change.

Financial corporates

Recommendation 4.11

- The PRA should confirm that funds also form part of financial corporate definition.

Rationale

The Advanced IRB approach is being removed for 'Financial Corporates', consistent with Basel proposals. The sub-class of 'financial corporates' is broader than 'FSEs' and includes other financial corporates such as pension funds. These are also low default in nature and firms face similar challenges with regard to the ability to model LGD.

Covered Bonds

Recommendation 4.12

- The PRA should reconsider the application of the 11.25% Foundation LGD to only UK covered bonds and apply to non-UK covered bonds too.

Rationale

Exposures to covered bonds currently treated under the Advanced IRB approach will be required to move to the Foundation IRB approach. Under this approach, firms are able to apply a beneficial LGD value of 11.25%. This is however limited to exposures to CRR covered bonds i.e. those that are issued by UK banks. There does not appear to be any risk-based justification for having a differentiated treatment between covered bonds issued by UK banks from other jurisdictions, particularly those such as in the EU. Such a differentiated treatment of covered bonds is also not envisaged in the Basel framework. We also discuss the limitations in relation to CRR Covered bonds in our response to the CRM section.

Question 20: Do you have any comments on the PRA's proposed approach to roll-out, permanent partial use, and reversion?

PPU within roll-out classes

Recommendation 4.13

- The PRA should reconsider the proposed PPU thresholds and/or the criteria that determine whether a portfolio is "non-modellable".

Rationale

For certain roll-out classes within firms, 5% would only capture a relatively small proportion of portfolios that currently use the Standardised Approach meaning that the other portfolios would need to meet the criteria for "non-modellable" or internal models would need to be developed.

UK Finance finds that this distinction between "immaterial" and "non-modellable" within the individual sub-classes is unnecessary and could result in institutions being obliged to develop IRB models for portfolios, considered immaterial within the institution for no purpose other than to meet an arbitrary target, on the grounds that they did not meet the 3 criteria set out in 150B (2)(a). This would add a significant burden on both firms and the PRA's resources.

Proposal

We recommend removing the distinction between "immaterial" and "non-modellable", thus allowing up to 50% of RWA to be calculated under the standardised approach within each roll-out class without any additional conditions.

Should the PRA decide to retain the distinction between "immaterial" and "non-modellable", we would recommend the following changes:

- Increase the immaterial threshold in each roll-out class to 15%; and
- Revise the "non-modellable" criterion in Article 150B(2)(a)(ii) so that firms are not required to develop internal models where they would not expect to fully comply with all requirements set out in this Part. The firm would need to justify this to your satisfaction (e.g. where such internal models would not be expected to comply with Use Test requirements, since the output would be used solely for calculating UK consolidated capital requirements). This would replace the current criterion given by Article 150B(2)(a)(ii), which is limited only to situations where "compliant modelling approaches are not feasible due to the nature and complexity of the type of exposures".

Question 21: Do you have any comments on the PRA's proposals relating to the 1.06 scaling factor and to the 1.25 asset value co-efficient of correlation multiplier?

Recommendation 4.14

- the size threshold for AVC application should be based on the borrower and its subsidiaries rather than total group asset.
- AVC should also explicitly not apply to funds and treasury entities of non-financial corporates which weren't intended to be captured to begin with.

Rationale

In relation to the application of the asset value correlation ('AVC') coefficient, we support the changes to the definitions of large financial sector entity ('FSE') and removal of the equivalence provisions. However, we consider that the application of size threshold should remain in relation to the borrower and its subsidiaries not on a total group consolidated basis. This is consistent with Basel requirements.

Furthermore, we consider that additional changes are required to ensure a coherent approach to the application of the AVC multiplier:

- Specifically, the definition of FSE may inappropriately capture treasury entities of non-financial groups whose sole purpose is to perform financial services to its wider non-financial group. If the non-financial group were to be structured differently and activities were to be performed out of an operating entity, the AVC multiplier would not apply; however due to structural decisions with financial activities in a separate legal entity, an AVC multiplied would apply. Such entities should be explicitly carved out of the scope of the AVC as we do not believe these were intended to be captured.
- Under the current guidance provided by the EBA, funds are not considered to be FSEs. This should be explicitly defined within the PRA rules to avoid any confusion.

Question 22: Do you have any comments on the PRA's proposal to remove the SME support factor under the IRB approach? Do you have any evidence – quantitative or

qualitative – regarding the appropriateness of the IRB approach for SME exposures in the absence of the support factor?

Recommendation 4.15

- the SME support factor should be retained.

Rationale

Please refer to our response to Question 11 in the standardised chapter.

We would also highlight that while the new 85% RW for corporate SMEs provides some relief under the standardised approach, there is no equivalent relief for exposures under the IRB approach, as the firm size adjustment applies under current rules.

Several members will carry out the analysis of the firm-size adjustment suggested in paragraph 4.137 of the CP and will include details in their individual firm responses. In addition, some members will include information in their individual firm responses covering the impact of removing the SME support factor and how it may impact margins paid by clients or impact returns, which could have a knock-on impact on the availability of credit to this key industry sector.

Proposal:

Should the removal be only delayed, it is recommended to consider a phased approach instead of a sudden change with immediate effect.

SME definition[5]

Recommendation 4.16

- The SME definition should be made simpler to implement by aligning to the Basel definition and set the thresholds to round GBP numbers.

Rationale and proposals:
Please refer to our response to Question 11 in the standardised chapter.

Question 23: Do you have any comments on the PRA's proposal to remove the infrastructure support factor under the IRB approach? Do you have any evidence – quantitative or qualitative – relating to the appropriateness of the IRB approach for infrastructure exposures in the absence of the support factor?

Please see our response to Question 10, but in addition:

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[5] this recommendation applies regardless of whether the SME support factor is retained or not

Recommendation 4.17

- We believe that the infrastructure support factor (ISF) should be retained.
- At the very least, we propose a transitional period for the removal of infrastructure support factor.

Rationale

Sustainable infrastructure and cleantech financing is a strategically important business for many banks as they support society's net zero agenda.

Losing the capital benefit under ISF is more critical for IRB firms given the absence of mitigants, such as the high-quality Project Finance risk weight of 80% RW for under SA. IRB exposures which are capitalised under the slotted approach mostly already fall into the strong category. For other exposures, there is little scope to amend the models used due to the impact of input floors.

At the very least, we propose a transitional period for the removal of infrastructure support factor in recognition of the long lead times to lend, the long-term nature of infrastructure contracts and the complex, strict and narrow application criteria that firms must meet to benefit. The ISF has enabled the bank to support green and sustainable financing where it would not usually be able to give some of these transactions have a lower return and would not meet bank internal thresholds for new business. Removal of the support factor – given EEA banks expect to retain via the EU CRR3 – would impact the competitiveness of UK banks in this area.

Question 24: Do you have any comments on the PRA's proposed approach to calculation of risk-weighted assets and expected loss, not covered by the questions above?

Recommendation 4.18

- The definition of commitment should be uniform across all approaches with no deviations under IRB. The unrecognised exposure adjustment should be removed to achieve this.

Rationale

As set out in the response to the Question 4, a clear and consistent definition of 'commitment' across all RWA methodologies should be applied since this will serve to minimise operational complexity when applying the output floor calculation. It is our view that this should align to the Basel 3.1 definition, including the implementation of the national discretion provided in Footnote 43 to Basel, with no further deviations under IRB.

The introduction of unrecognised exposure adjustment' is intended to extend beyond existing expectations that are already part of the SS 11/13 under advanced IRB. In particular it is being extended to include items which are not off-balance sheet and to be applied across all IRB exposures. It is unclear what this is intended to cover. This not only creates a practical burden but more importantly a significant deviation between the standardised and IRB approaches

regarding what constitutes a commitment, and subsequently should be considered an exposure attracting capital requirements.

Clarity is needed on what types of exposures are in scope of CRR Article 166A(6) sub-point (b):"facilities or relationships where otherwise not classified as off-balance sheet items". We understand from the recent PRA meeting with UK Finance that the PRA expects this adjustment to be carried out on a 'best efforts basis'. If this is the case, and this concept is retained we are of the strong view that this should be maintained in the supervisory statement and not included in the PRA rulebook.

A further deviation under the Advanced IRB is set out in the proposed supervisory statement (Appendix 13, paragraph 17.11) which relates to delay recognition of an exposure where the commitment is subject to a further credit assessment. This introduces complexity into the regulatory framework by creating a divergence between standardised and IRB approaches which will be evident in the application of the Output floor. This deviation between approaches should be removed and replaced with the national discretion in Footnote 43 which would deliver the same outcome.

Question 25: Do you have any comments on the PRA's proposed general requirements for the use of the IRB approach?

IRB model governance and validation

Recommendation 4.19

- The PRA should provide further clarity how "material differences between established procedures and actual practice" would apply in practice (Para 4.175).

Rationale

It is an existing requirement for senior management to provide notice to the management body of exceptions to established policies (UK CRR Article 189(2)(a)), hence the proposal seems redundant with existing regulatory requirements without further clarification to be able to support banks' compliance with the PRA expectations

Adjustments to address lack of representativeness

Recommendation 4.20

- paragraph 34 of EBA GL 2017/16 should be included in Appendix 13 to maintain consistency with the EU guidelines supporting the regulatory requirements.

Rationale

The updated CRR article 174(c) indicates that the data used to build models should be representative of the population of the institution's actual obligors or exposures. Paragraphs 28-34 of EBA GL 2017/16 provide additional clarity on representativeness of data for calibration of risk parameters. This is largely adopted in Appendix 13, paragraphs 8.10 to 8.14,

however paragraph 34, which allows for adjustments to be made and MoC to be applied in cases where limitations in representativeness have been identified, has not been included. This would mean that firms would need to have fully representative data at the outset (due to the expectation of Article 174(c)). This is not considered a realistic expectation for all portfolios and therefore it is recommended that paragraph 34 of EBA GL 2017/16 is included in Appendix 13 to allow adjustments to be made to correct for biases/non-representativeness in the data.

Seasoning assessment and adjustment

Recommendation 4.21

- Extend the regulatory text stating that MoC would not be required if firms can demonstrate that seasoning effects are already captured by the model.

Rationale:

Paras. 10.6 and 12.24 of Appendix 13 for PD and LGD respectively set the expectation that firms adjust their estimates with an adequate MoC to account for any lack of representativeness caused by seasoning. Clarification is requested that a MoC would not be required if firms can demonstrate that seasoning effects are already captured by the model, i.e. the model does not underestimate risk through time.

Proposal:

Further consideration is needed for LGD specifically, where Para 12.24 initially refers to “time from the date of default” when discussing seasoning, but subsequently refers to default rates peaking several years after origination i.e. referring to “time since origination”. Aging of defaults and time on books are not directly connected, therefore clarification is requested that the LGD seasoning assessment is related to aging of defaults only and not time on books.

Question 26: Do you have any comments on the PRA’s proposed approach to the definition of default?

Continued use of MIA

Recommendation 4.22

- Extend the PRA rulebook and explicitly allow the use of MIA as a substitute of “days past due”.

Rationale

In PS7/19 paragraph2.20, the PRA outlined that 0% relative materiality threshold £0 absolute threshold for Retail exposures are designed to be appropriate for when a ‘months in arrears’ (MIA) payment allocation scheme is used by the firm. While the retail materiality thresholds have been designed to be appropriate for the ‘months in arrears’ approach, they are applicable to all retail exposures, irrespective of the payment scheme used (paragraph 2.22 PS7/19). These paragraphs implied firms using MIA approach are not required to change their approach

for calculation arrears in order to be compliant with CRR Article 178 and relevant EBA Guidelines (EBA GL2016/07).

The draft supervisory statement on definition of default (Appendix 14 of CP16/22) and the draft Rulebook (appendix 4 of CP16/22), do not explicitly give allowance for use of 'months in arrears' approach and the language in these documents is aligned with that of the EBA GL2016/07 (EBA Guideline on definition of default which implicitly disallowed use of devisor approach). Our understanding is that the proposals are not intended to change the PRA's commitment, made in PS7/19 paragraph 2.23, not to be prescriptive in terms of payment approach. We believe it would be useful if an explicit confirmation of this was to be made in the final Supervisory Statement text.

Treatment of forborne exposures / distressed restructuring

Recommendation 4.23

- We welcome the regulatory amendments to the PRA rulebook but further suggest changes to provide clarify.

Rationale

In the EBA's existing Guidelines on the application of definition of default (EBA/GL/2016/07), the EBA had aligned the definition of 'distressed restructuring' with the definition of forbearance used for supervisory reporting (see Page 99 in the Q&A section of EBA/GL/2016/07). In addition, paragraph 54 of the EBA Guidelines contains a further explicit link between distressed restructuring defaults and forborne non-performing exposures. Paragraphs 3.15 to 3.19 in Appendix 14 do not include the references to 'forborne non-performing exposures' that is currently contained in paragraph 54 of EBA/GL/2016/07. We welcome this decision and recommend it is retained in the final draft rules, as we believe this expectation is overly burdensome to implement in practice.

Proposal:

We would also recommend the following change:

Paragraph 8.2 in Appendix 14 still contains a reference to 'forborne non-performing exposures', which we believe has been included in error from paragraph 107 of EBA/GL/2016/07. As the link to 'forborne non-performing exposures' has been removed in paragraphs 3.15 to 3.19 in Appendix 14, we recommend that this reference is also deleted from paragraph 8.2, in order

We noted an error in Article 178 in the new PRA rulebook in Article 178(2) (da), for which the materiality threshold is £440 million rather than £440.

Question 27: Do you have any comments on the PRA's proposed PD, LGD, and CF or EAD input floors?

PD input floors for QRRE

Recommendation 4.24

- We recommend aligning the final rule set for retail exposure PDs to the Basel 3.1 requirements.

Rationale

The consultation paper states that 0.1% and 0.05% PD floors are applicable to QRRE transactor exposures and other QRRE exposures respectively, whilst Article 163(1) of the updated CRR states that all QRRE exposures will be subject to a 0.1% PD floor. This appears contradictory. The recommended approach would ensure an appropriate risk sensitivity is applied to QRRE transactors, which are inherently lower risk than other types of QRRE exposures by aligning with BCBS CRE 23.58.

0.1% PD floor UK mortgage & QRRE transactor exposure

We welcome that the PRA notes that the 10% UK retail residential mortgage portfolio-level risk weight floor has now become a formal requirement. Key drivers of this are to reduce unwarranted RWA variability, better align competition with Standardised firms, and capture the additional risk for model uncertainty. However, considering the mortgage portfolio RW floor, and the introduction of the UK-specific hybrid PD approach, application of the additional 0.1% PD floor appears excessive. There are two points worth highlighting.

- Firstly, all obligors / exposures, except the transactors within the Qualifying Revolving Retail Exposure sub-class, will receive a 0.05% floor. Given these are traditionally higher risk products, and that the RW floor captures an element of model uncertainty, the higher floor is deemed to be overly prudent.
- Secondly, the CP notes that non-UK-retail residential mortgages would be subject to the 0.05% floor. This suggests that UK mortgages (including prime mortgages) are riskier than other jurisdictions and may lead to a negative impact for UK competition. We find this assumption to be overly prudent.
  As such, and in line with wider Basel implementation, we would be supportive of the introduction of a 0.05% floor for UK retail residential mortgages.

Question 28: Do you have any comments on the PRA's proposals on PD estimation?

Point in Time plus Buffer methodology

Recommendation 4.25

- It is recommended to clarify and confirm the possibility in the final ruleset the use of the widely implemented "Point in Time Buffer" approach for retail unsecured portfolios.

Rationale

It felt that the mandatory discrete rating scale introduction would discard the option to use for retail unsecured exposures the "Point in Time Buffer" approach. Clarification is requested that the Point in Time plus Buffer approach would still be allowed under the new proposals (in association with discrete rating scales, should the PRA disallow use of continuous rating scales).

LRA default rate calculation

Recommendation 4.26

- Clarification is suggested in the final regulatory text on how the long run average PDs should be estimated – and whether this differs from the current regulatory framework provided in point (a) of CRR Article 180 (1) and (2) and Sections 5.3.3 and 5.3.4 of EBA GL 2017/16 (which align with 36.63 of Basel 3.1).

Rationale

The updated CRR article 180(1)(aa) and (2) (aa) sets the expectation that long-run average PDs should be estimated based on the observed historical average one-year default rate that is a simple average based on the number of obligors (count-weighted). It appears that the wording in point (aa) is conflating the calculation of the one-year observed default rate (which should be count-weighted, as specified in Para. 11.4 of Appendix 13), and the long run average default rate (which should be time-weighted, as specified in Para. 11.11 of Appendix 13).

Representative mix of good and bad periods

Recommendation 4.27

- The PRA should specify 'the years that constitute, for UK portfolios, 'the representative mix of good and bad periods"
- The PRA should allow the use of macroeconomic data/other external factors to back-cast default/loss data

Rationale

In the updated CRR Article 180 (1)(h) and (2)(e), the PRA sets the expectation that "the data shall include a representative mix of good and bad years from the economic cycle relevant for the type of exposures". It may not be possible to meet this requirement for portfolios/geographies where the available internal/external/pooled default/loss data history does not cover a representative downturn period and economic cycle. The PRA could clarify whether this data requirement could include the use of macroeconomic data/other external factors which are then used to estimate default/loss data covering a representative mix of good and bad years.

Proposal

The PRA should specify 'the years that constitute, for UK portfolios, 'the representative mix of good and bad periods" for the purpose of PD calibration, as this will remove unwarranted variability in RWAs introduced by firm-specific interpretation, driving greater consistency and comparability of outputs.

It should also allow the use of macroeconomic data/other external factors to estimate (back-cast) default/loss data covering a representative mix of good and bad years which can form part of the final estimation where the available internal/external/pooled default/loss data history does not cover a severe downturn period and/or an economic cycle

Obligor grade adjustment, i.e. parental support

Recommendation 4.28

- Firms should continue to be allowed to use parental support for PD adjustments without the need for documented parental support.

Rationale

Whilst we welcome the PRA's recognition of the use of parental support arrangements. We note that the PRA proposes to introduce new requirements for the recognition of support arrangements in PD models (4.226-8), which excludes undocumented support arrangements.

The ability to take account of parental support is an integral part of several client management framework for global banking business. It is important for global clients that we are able to provide banking facilities to their global subsidiaries in a way that reflects the credit quality of the client group.

Banks' parental support frameworks have been in place prior to the introduction of the IRB regulations in 2008 and uses the parent's Credit Grade as the key input (with the exposure receiving a level of notch downgrade from the parent's grade that is dependent on the level of support). This is consistent with the approach taken by the Rating Agencies and reflects our experience that the key determinant of risk for global subsidiaries is the credit quality of the parent.

A key requirement of banks' framework is that for any support to be taken into account, the parent must be highly rate (i.e., a maximum of one notch below investment grade). This ensures that the parent is of a standing that they would have both the ability and willingness to support their subsidiaries.

Banks' historic long-run default rates by the type of support illustrates that the internal governance banks' apply when taking account of parental support leads to lower default rates.

PRA has said[6] that its preference is for parental support to be used as an input to the PD model, however the PRA then notes[7] that it considers undocumented support arrangements

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[6] ***CP16/22 4.226:*** *The PRA considers that it would be desirable for firms to reflect support arrangements in PD models where they are able to demonstrate a reduction in default risk, as the PRA considers that linking RWAs to risks advances the PRA's primary objective. As such, the PRA proposes to continue to permit firms to reflect certain support arrangements in IRB obligor rating grade assignments.*

[7] ***Section 4.227****: However, the PRA considers that undocumented support arrangements are often unclear and not robust. In addition, the PRA considers that it is difficult for firms to demonstrate a reduction in default risk from*

'often unclear and not robust'. In addition, the PRA considers that it is difficult for firms to demonstrate a reduction in default risk from these arrangements, and it is difficult for supervisors to challenge whether these arrangements are appropriately reflected in IRB models.

Providing banking facilities to subsidiaries is an integral part of global business for banks, we believe that we can demonstrate that the application of our parental support framework for the different types of support (including undocumented support) is robust. The reduction in default risk from these different types of support can be seen in our historic data. Firms should be given the opportunity to demonstrate to the PRA that their parental support arrangements are adequately reflected in their IRB models. This would be consistent with the IRB approach of firms using their own data to select and support the key risk drivers used in their models, to derive capital requirements that are aligned to the historic risk of their portfolios. Curtailing the benefit that can be given for certain types of support will unnecessarily hinder our ability to support the global expansion of UK companies. Increasing the cost and limiting the types of banking facilities that the subsidiaries of UK businesses would have access to.

Furthermore, it is our understanding that the EU approach will remain the same, and we expect HK and Singapore's approach to also remain unchanged, i.e. to allow the obligor grade adjustments to be recognised in PD modelling without a specific requirement for documented parental support. Where other local jurisdictions do not have this requirement, this will also increase capital and/or costs – both compliance and operational – for banks required to do so by their home regulator and potentially impact competition in other markets.

Proposal

UK Finance requests the removal of the requirement that proposes that adjustments to obligor grades would only be permitted where the support arrangements are in writing.

Question 29: Do you have any comments on the PRA's proposals to LGD estimation?

Additional drawings after default

UK Finance welcomes the PRA proposal, to permit additional drawings after default to be recognised in LGD estimates for non-retail exposures, as an alternative to the existing UK CRR requirement to only recognise them in EAD estimates.

Ineligible collateral treatment

Recommendation 4.29

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these arrangements, and it is difficult for supervisors to challenge whether these arrangements are appropriately reflected in IRB models. The PRA therefore proposes that adjustments to obligor grades would only be permitted where the support arrangements are in writing.

- For disregarded and ineligible collateral, UK Finance recommends PRA retains the existing approach to include them in the model calibration.

Rationale

The PRA requires that cashflows associated with disregarded and ineligible collateral are not included in LGD estimates. This is a change to the existing requirements which permit their inclusion in the model calibration, but not as a risk driver, subject to making any adjustments to avoid bias to the LGD for unsecured exposures (paragraph 127 EBA/GL/2017/16). The exclusion of these cash flows will bias the real recovery amount and hence bias the LGD incurred by the firm.

Proposal

While we support your approach on not including disregarded and ineligible collaterals as risk drivers, we recommend that you should allow them to be included in the model calibration, especially when the recoveries have a material effect on losses during a downturn period.

Alternative methodology for collateral in LGD estimation

Recommendation 4.30

- For the use of the alternative methodology for collateral in LGD estimation, UK Finance recommends the PRA clarifies what is meant by 'relevant data points'.

Rationale

In Para. 4.249 of Chapter 4, the PRA indicate that the alternative methodology should be adopted where firms have fewer than 20 relevant data points for any non-financial collateral. The threshold of 20 relevant data points is not included in Article 169B(1)(b), which refers only to having sufficient data to model.

Proposal

UK Finance requests that the threshold of 20 relevant data points is included in Article 169B(1)(b), along with a clarification of what "relevant data points" means in the context of a Mortgage LGD model.

Incomplete workouts

Recommendation 4.31

- For the treatment incomplete workouts, UK Finance recommends the PRA clarifies the requirements for the treatment of costs and recoveries.

Rationale

In Para. 14.12(b) of Appendix 13, the PRA provides an option for the LGD calibration to assume zero future costs and recoveries for incomplete workouts, but it is unclear whether

this option applies to all parts of the LGD model, including Best Estimate of Expected Loss ('BEEL') estimates.

In addition, paragraph 14.12(b) of Appendix 13 indicates that costs and recoveries for 'incomplete workouts' (defaulted facilities that have not completed the 'maximum period of the recovery process') can be estimated only up to the maximum period of the recovery process, whilst Paras 14.6, 14.10(b) and 14.11 indicate that costs and recoveries for unresolved workouts (defaulted facilities that have completed the 'maximum period of the recovery process') can be included up to the moment of estimation.

These restrictions on the timing of recovery cash flows for incomplete and unresolved workouts do not align with the guidance recently provided by the PRA at the Mortgage Roundtable in October 2022, where it was noted that "the most conservative approach consists of classing all these exposures as a repossession event") i.e. unresolved exposures at the maximum period of the recovery process can be assumed to be repossessed, thus allowing the recognition of appropriate collateral recoveries. Excluding such collateral recoveries means that model estimates would not be reflective of actual risk management practices and could lead to illogical LGD estimates.

Proposal:

UK Finance requests that the PRA clarifies whether the option to assume zero future costs and recoveries applies to all parts of the LGD model, including Best Estimate of Expected Loss ('BEEL') estimates.

We also recommend aligning to the expectation set out in the October 2022 Mortgage Roundtable, by allowing appropriate recognition of collateral recoveries post the maximum period of the recovery process for the purpose of LGD estimation.

Calibration to a long-run average

Recommendation 4.32

- For the calibration of long-run averages at the level of the calibration segment, UK Finance recommends that this is also available where discrete rating scales are used.

Rationale

In Para 14.15 of Appendix 13, the PRA sets the expectation that long-run average LGDs can only be calibrated at the level of the calibration segment when using a continuous rating scale. This approach need not be restricted to continuous ratings scales but also allowed where discrete rating scales are used when only a portfolio level calibration target is available.

Proposal:

UK Finance requests that calibration at the calibration segment level is allowed for discrete LGD model estimates when only a portfolio level calibration target is available. For example,

in the situation where the downturn LGD impact needs to be estimated in accordance with Paras. 15.17-15.23 of Appendix 13.

Structure of Appendix 13

Recommendation 4.33

- In Appendix 13, LGD requirements are separated out into several sections. Section 12 is titled "LGD – Model Development" but includes some requirements that would be considered as general requirements, applying to both Model Development and Model Calibration. UK Finance recommends that a similar structure could be adopted to the EBA GL 2017/16, where general requirements and model development requirements are separated out into two separate sections.

Question 30: Do you have any comments on the PRA's proposals to EAD estimation?

Consistency of EAD estimation with other components

Recommendation 4.34

- To preserve the consistency in estimation among the different risk parameters, it is recommended to keep the possibility to model EAD/CCF with a cohort approach, rather than using a fixed time horizon approach, which would give estimate to only one single point in the future rather than any possible event in the next 12 months.

Rationale

Article 182.1(g) requires conversion factors are estimated based on information as at 12 months prior to the point of default. This is inconsistent with PD estimation where the point of default is at any point in the next 12 months rather than at precisely 12 months. This could lead to inconsistencies in EL and RWA calculations.

EAD estimation for non-revolving exposures

Recommendation 4.35

- It is recommended to specifically allow or discard the usage of the currently widely adopted methodologies for closed end loans (i.e., capital repayment mortgages, fixed term personal loans), using current balance adjusted with the expected number of missed payment related interest added to the balance as an EAD estimate.

Rationale

Article 166D of the updated CRR prohibits modelling of conversion factors/expected outstanding amount at default for on-balance sheet items. Currently, it is common practice to estimate EAD for on-balance sheet items on non-revolving facilities (e.g. mortgages,

unsecured loans) as the on-balance sheet amount plus an expected amount of accrued interest over the months of non-payment in the lead-up to default. We request clarification on whether this approach remains acceptable.

Question 31: Do you have any comments on the PRA's proposals for maturity?

PRA proposal to maintain the substance of its existing approach, being to apply the effective maturity approach, is welcomed.

1 year maturity floor

Recommendation 4.36

- The PRA should use the Basel framework national discretion to include inter-bank deposits and nostro accounts as exempt from the one-year floor.

Rationale

In Basel 3.1 (CRE32.53), a list is provided for "other short-term exposures with an original maturity of less than one year that are not part of a bank's ongoing financing of an obligor", that may be eligible for exemption from the one-year maturity floor. There is national discretion as to which exposures may be exempt from this. We suggest that the PRA extends qualifying short-term exposures to also include inter-bank deposits and nostro accounts which should be eligible for 1 day maturity floor. These exposures are by their very nature short term and are not part of the borrowers ongoing financing.

Purchased Receivables

Recommendation 4.37

- Self-liquidating trade finance transactions should be eligible for the one-day maturity floor.

Rationale

We note that the PRA has proposed to align treatment of effective maturity for purchased receivables with the Basel 3.1 standards of a minimum of one year in lieu of the existing 90-day minimum. Our view is that purchased receivables exposures which are self-liquidating trade finance transactions, satisfying the definition for 'trade finance' set out in CRR Article 4(1)(80), should be eligible to for the maturity floor of one day. For other purchased receivables exposures which do not fall within the scope of the 'trade finance' definition, a default maturity floor of one year would be applicable.

Question 32: Do you have any comments on the PRA's proposals for specialised lending?

<u>Object finance (i.e. physical collateral (aircraft/shipping))</u>

Recommendation 4.38

- We recommend that the PRA review the LGD floors for specialised lending to differentiate specialised global movable assets, like aircraft and ships, from general 'other physical collateral'. We also recommend that the PRA consider phase-in of LGD floors for specialised lending and the SA object finance RW of 80%.

Rationale

The advanced IRB LGD floor for 'Other Physical Collateral' is 15%, and the fixed input under foundation IRB is 25% with a 40% haircut. In our view, this is too high when comparing with the specialised lending recovery data. In addition, these LGD inputs for aircraft and shipping asset-backed financing do not reflect the actual loss rates for aircraft-backed exposures. Global Credit Data (GCD) 2022 research indicates aircraft-backed observed recovery rates of 90% and shipping-backed recovery rates of 86%, reflecting higher recoveries than typical corporate loans[8].

Our understanding is that many EU peers are able to maintain advanced IRB permissions for aircraft and ship financing under specialised lending. Any adjustments to the input floors made by the EU will adversely affect UK bank global competitiveness.

Proposals:

LGD floors for each specific category of specialised lending should be reviewed to differentiate specialised global movable assets, like aircraft and ships, from general 'other physical collateral'.

To support the competitiveness of UK banks, we request to align with the European Commission proposal under the EU CRR3 under Article 495B to phase in the LGD floors for specialised lending exposures over a four-year period.

As noted in the UK Finance response to the SA chapter, we would also like to see consideration of the SA object finance RW of 80% to address the lack of granularity in the framework and reflect the difference in risk to an unsecured general corporate given direct recourse available to the underlying physical collateral.

Specialised lending category definitions – HVCRE

Recommendation 4.39

- We recommend that the PRA do not introduce the HVCRE classification. Instead, the increased risk associated with HVCRE could be reflected in capital requirements by capturing the risk drivers of HVCRE in the assignment of slotting categories.

Rationale

[8] https://globalcreditdata.org/wp-content/uploads/2022/05/GCD-Aircraft-RR-Dashboard-2022.pdf ,
https://globalcreditdata.org/wp-content/uploads/2022/08/GCD-Ship-RR-Dashboard-2022-v1.1-1.pdf

The HVCRE category will be difficult to implement because the proposed definition is complex and requires a number of judgment calls. For example, the definition requires firms to define and determine “speculative” lending and “cash flows whose source of repayment is substantially uncertain” and consider whether ADC borrowers have “sufficient equity to absorb most losses through the ADC phase in a severe but plausible scenario”.

The complexity and judgment calls will likely lead to inconsistency in HVCRE classification between firms and even within firms where different credit officers take different views.

The complexity added by the HVCRE classification does not appear to be justified by its impact, given CP16/22 states that “the PRA assesses that HVCRE is unlikely to be a significant exposure class for most firms”.

Not introducing the HVCRE category would align with the EU. This would support UK competitiveness and simplicity for firms with a presence in the UK and the EU.

Proposals

We propose that the PRA do not introduce the HVCRE classification. Instead, the increased risk associated with HVCRE could be reflected in capital requirements by capturing the risk drivers of HVCRE in the assignment of slotting categories.

If the PRA do introduce the HVCRE classification, we suggest making the definition much simpler so that it can be more easily and consistently implemented. The Basel definition refers specifically to categorisation by the national supervisor, and we recommend consistency with equivalent regulatory jurisdictions.

Introduction of additional risk-sensitivity in the slotting approach – maturity criteria

Recommendation 4.40

- Continue to use the simple 2.5-year residual maturity criteria for the preferential risk weights, for all types of specialised lending.

Rationale

CP16/22 proposes expanding the maturity criteria for preferential risk weights: in addition to whether remaining maturity is less than 2.5 years, the firm must “reasonably consider that the obligor could refinance the exposure in a severe but plausible stress in the refinancing market”, whilst the Basel text does not contain this further condition.

This proposal adds complexity and creates inconsistency with other capital approaches. Firstly, in other IRB approaches, the maturity factor (M) is assigned without consideration of refinancing potential. Secondly, introducing consideration of a “severe but plausible stress”

brings stress testing into the Pillar 1 framework in a manner inconsistent with the remainder of the capital framework, and is subjective so will result in inconsistency between firms.

We understand that the main driver of the proposed change from CP16/22 para. 4.324 appears to be related to the fact that high quality loans that have a residual maturity greater than 2.5 years do not currently benefit from the preferential treatment; not that the risk of the current short-term loans is being appropriately picked up.

As such, we would be supportive of keeping the simple 2.5-year residual maturity criteria, but with an exception such that loans with greater than 2.5 years residual maturity could also receive the preferential risk weights where they meet the 'substantially stronger' criteria (explored in our next recommendation).

We find this to be an appropriate balance to allow existing slotting approaches to continue to apply the preferential criteria based on residual maturity (and be in line with Basel text), while also allowing longer term exposures to benefit from preferential RWs and ELs where additional conditions are met.

Proposal

We recommend continuing the existing approach to maturity, whereby all exposures in the 'strong' and 'good' categories with residual maturity of less than 2.5 years receive the preferential risk weights, without having to consider refinancing potential. This is in line with the Basel text.

Introduction of additional risk-sensitivity in the slotting approach – 'substantially stronger' criteria for IPRE

Recommendation 4.41

- Revise the 'substantially stronger' criteria for assigning preferential risk weights to IPRE exposures with residual maturity of more than 2.5 years.

Rationale

CP16/22 proposes assigning preferential risk weights based on 'substantially stronger' criteria for IPRE exposures specifically. We support the ability to assign the preferential risk weights for longer term exposures that do not meet the maturity criteria but have several issues with the PRA's proposed additional implementation criteria for IPRE based on CP16/22 para.4.328:

- The three conditions for being 'substantially stronger' set the bar too high, especially condition (i) which requires that the exposure be slotted into category 1 for all factors.

  Therefore only category 1 exposures can be 'substantially stronger', whereas in the Basel text both category 1 and 2 exposures can be. We would be supportive of this alignment to both 'strong' and 'good' exposures.

- Conditions (ii) and (iii) add significant complexity because they contain subjective clauses that require interpretation, such as *"substantially below the market norm"* and *"investment grade or equivalent"* (noting that most tenants do not have external ratings). As for wider exposure classification points, if these criteria remain as worded we would be supportive of the PRA providing clarity so firms consistently apply a 'market norm' and define a consistent threshold for 'substantially below', for example.
- Condition (ii), requiring the leverage of the obligor to be "*substantially below the market norm*", could lead to lower risk weights when the market norm leverage level is high and higher risk weights when the market norm leverage level is low, which is counterintuitive.

Proposal

For IPRE exposures in the 'strong' and 'good' categories with residual maturity of 2.5 years or more, revise the 'substantially stronger' criteria to be simpler and less restrictive. Our ideas are as follows:

1. Instead of the proposed criteria, assign the preferential risk weights to exposures with LTV below the bank's LTV threshold for the relevant slotting category ('strong' or 'good'). For example, if a bank sets its LTV threshold for the 'good' category at 60%, then a 'good' exposure with 50% LTV would be assigned the preferential risk weight. This idea is driven by the current limited impact of LTV on risk weights under slotting, where LTV only impacts slotting risk weights if it causes an exposure to move category, in comparison to other IRB approaches where LTV has a direct impact via LGD in the risk weight formula.
2. Adopt the proposed criteria with the following changes:
    a. Apply the preferential risk weights if *at least one* of the criteria is met, rather than *all* of the criteria. This would mitigate condition (i) setting the bar too high.
    b. Expand condition (i) so 'good' exposures with residual maturity of 2.5 years or more are also eligible for the preferential risk weights. So, for 'good' exposures, the condition would be that the transaction is not assigned to a category worse than 'good' for any factor.
    c. Reduce the complexity and subjectivity of conditions (ii) and (iii).

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