Summary of CP16/22 Implementation of Basel 3.1 Standards

Key Takeaways for Specialised Lending Exposures

DECEMBER 2022

TRUE NORTH PARTNERS
FINANCE | RISK | STRATEGY

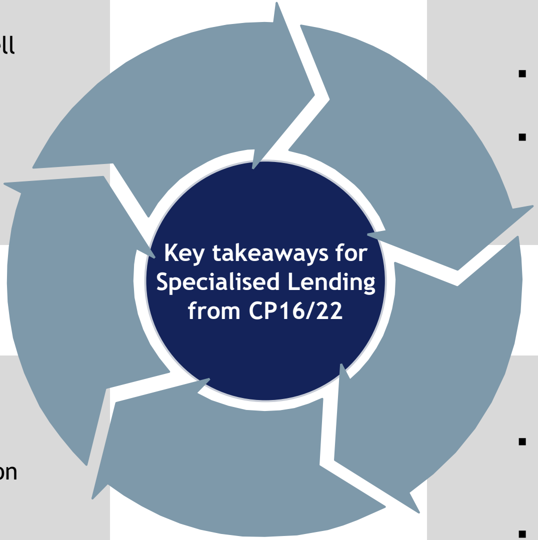
Outline

- Overview
- Interpretation of Proposed Changes to Requirements for:
  - Scope and Modelling Approach
  - Capital Calculation
  - Monitoring and Governance
- Appendix 1: Definitions
- Appendix 2: Who are we

Disclaimer

TNP neither owes nor accepts any duty, liability or responsibility in respect of the information presented. All decisions and remedial actions determined necessary following the reading of this document remain the responsibility of the reader. Receipt of this presentation does not constitute an engagement of work and it is recommended that the reader substantiates any information by referring to the referenced source material.

Overview



Scope

- The definition of the Specialised Lending (SL) asset class as well as the sub categories has been crystalised
- A new sub-category has been introduced outside the well known SL sub-categories. Income Producing Real Estate (IPRE) has been split up to capture additional risk sensitivities – High Volatility Commercial Real Estate (HVCRE) is now a separate category where greater uncertainties and loss rates are expected

Capital Calculation

- This CP proposes a slight variation to the risk weights and expected loss (EL) values, compared to what is currently in the CRR
- Infrastructure Support factor has not been permitted under any approach
- The new proposal is deemed more conservative, however further factors have been introduced which allow lower risk weights for transactions with higher quality and stronger characteristics

Modelling Approach

- IPRE and HVCRE will only be permitted to use the Slotting approach
- Project Finance, Object Finance and Commodities Finance will be allowed to be modelled under Foundation (F-IRB) or Advanced (A-IRB) approach
- Exposure at Default (EAD) modelling will be withdrawn for the Slotting approach
- A benchmark with external ratings has been provided as a guidance corresponding to the slots

Monitoring and Governance

- Stronger monitoring requirements have been introduced to ensure that corporate exposures are not incorrectly allocated to the SL exposure sub-class
- Granular disclosure as per SL sub-classes has been proposed for standardised approach disclosure
- Higher, more specific data governance requirements have been introduced

Note: refer to the *Appendix 1* for a list of terms and definition

Scope and Modelling Approach

	Current Requirements[1]	Proposed Requirements of CP 16/22 (B3.1)
Specialised Lending (SL) Categories	▪ Project Finance ▪ Object Finance ▪ Commodities Finance ▪ Income Producing Real Estate	▪ Project Finance ▪ Object Finance ▪ Commodities Finance ▪ Income Producing Real Estate ▪ High Volatility Commercial Real Estate
Slot Categories	▪ Categories 1, 2, 3, 4, 5 as per CRR article 153(5)	▪ Strong, good, satisfactory, weak, default to align with the SS11/13 slotting criteria
Modelling Approach	▪ A-IRB and F-IRB are permitted for IPRE provided that compliance with CRR is ensured or any non-compliance is remediated	▪ A-IRB and F-IRB are not permitted for IPRE and HVCRE – only slotting approach is permitted ▪ A-IRB and F-IRB are permitted for Project Finance, Object Finance and Commodity Finance ▪ EAD modelling is not permitted for slotting approach
Benchmark with External Ratings (ECAI ratings)	▪ No specific benchmark available	▪ A set of external credit ratings corresponding to the slot categories has been proposed. For IPRE, the ratings are based on characteristics – "substantially stronger" and "otherwise" (see table below) ▪ Definition of substantially stronger included in appendix

SL category	Characteristics	Strong	Good	Satisfactory	Weak
IPRE	Substantially stronger	BBB+ or better	BB+ or BB	BB- or B+	B to C-
	Otherwise	BBB or BBB-	BB+ or BB	BB- or B+	B to C-
SL excl. IPRE		BBB- or better	BB+ or BB	BB- or B+	B to C-

1: Current requirements in the UK firms as per CRR and Supervisory Statements and RTS issued by the PRA

Capital Calculation

	Current Requirements	Proposed Requirements of CP 16/22 (B3.1)

Slotting risk weights drivers

Current Requirements

- Risk weights based on slot category and remaining maturity

Proposed Requirements of CP 16/22 (B3.1)

- Risk weights based on slot category, underwriting standards and remaining maturity
- Preferential treatment is allowed if less than 2.5 years remaining maturity and refinance capability under stress; and/or IPRE exposure with “substantially stronger” characteristics

Risk Weights under Slotting Approach

Current Requirements

Remaining maturity	Strong	Good	Satisfactory	Weak
< 2.5 years	50%	70%	115%	250%
>= 2.5 years	70%	90%	115%	250%

Proposed Requirements of CP 16/22 (B3.1)

SL category	Treatment	Strong	Good	Satisfactory	Weak
HVCRE	Preferential	70%	90%	140%	250%
	Non-preferential	95%	120%	140%	250%
All other	Preferential	50%	70%	115%	250%
	Non-preferential	70%	90%	115%	250%

Expected Loss under Slotting Approach

Current Requirements

Remaining maturity	Strong	Good	Satisfactory	Weak
< 2.5 years	0%	0.4%	2.8%	8%
>= 2.5 years	0.4%	0.8%	2.8%	8%

Proposed Requirements of CP 16/22 (B3.1)

SL Category	Treatment	Strong	Good	Satisfactory	Weak
HVCRE	Either	0.4%	0.4%	2.8%	8%
All other	Preferential	0%	0.4%	2.8%	8%
	Non-preferential	0.4%	0.8%	2.8%	8%

Risk Weights under Standardised Approach

Proposed Requirements of CP 16/22 (B3.1)

Where an external rating available:

Credit Quality	1	2	3	4	5	6
Risk Weight	20%	50%	75%	100%	150%	150%

For unrated exposure:

- Object /Commodity Finance = 100%
- Project Finance (PF) - pre-operational = 130%; PF - operational = 100%
- PF - operational and high quality = 80%

Infrastructure Support Factor[1]

Proposed Requirements of CP 16/22 (B3.1)

- Not available under Standardised or IRB including Slotting

1: Infrastructure Support Factor was one of the proposed reforms in Basel III standards by BCBS

Monitoring and Governance

	Current Requirements	Proposed Requirements of CP 16/22 (B3.1)
Data Governance	▪ Data governance requirements exist but details are at firm's discretion – e.g. HVCRE information is currently not required to be captured	▪ Specific definitions of SL sub-classes have been added (see definitions in appendix). Firms will be required to capture granular information on the IPRE exposure allowing HVCRE to be identified correctly ▪ Risk weights will depend on underlying characteristics of the transactions, thus, data requirement and governance will increase
Monitoring	▪ Monitoring requirements exist but granularity is at firm's discretion	▪ Enhanced monitoring required to ensure that proposed SL criteria and definitions have been implemented ▪ PRA has also introduced monitoring on allocation of Large Corporate exposures between general corporate exposure subclasses and SL subclasses, such that modelling approaches are consistent, more specifically A-IRB approach is not used for Large Corporate exposure (moving to F-IRB under Basel 3.1) by assigning them to one of the SL sub-classes where A-IRB is allowed
Disclosure	▪ Current UKB CR4 and UKB CR5 disclosure template only shows aggregated SL exposure under standardised approach ▪ Current UKB CR10 template has disclosure requirements across categories 1 to 5 and remaining maturities (less than 2.5 years and equal to or more than 2.5 years)	▪ Disclosure templates for standardised approach (UKB CR4 and UKB CR5 templates) will be modified to add SL sub-classes ▪ Disclosure templates for IRB approach (UKB CR10 template) will be modified to: – reflect increased risk sensitivity by adding HVCRE – add the new labels on slot categories, i.e., Strong, Good, Satisfactory, Weak, Default; and preferential treatment applicable or not – add the new risk weights

Appendix 1

- Asset Class Definitions
- Project Finance Specific Definitions
- Additional Definitions

Appendix: Asset Class Definitions (1 of 2)

Specialised Lending

An exposure is considered to be specialised lending if the following characteristics hold:

a. the exposure is to an entity which was created ***specifically to finance and/or operate physical assets***;
b. the borrowing entity has ***little or no other material assets or activities***, and therefore little or no independent capacity to repay the obligation, apart from the income that it receives from the asset(s) being financed;
c. the terms of the obligation ***give the lender a substantial degree of control*** over the asset(s) and the income that it generates; and
d. as a result of points (a) to (c) above, the ***primary source of repayment of the obligation is the income generated by the asset(s)***, rather than the independent capacity of a broader commercial enterprise.

Project Finance

An exposure is considered to be project finance if ***revenues are generated by a single project***, both as the source of repayment and as security for the exposure – Additional project finance specific definitions are included on page 9.

Object Finance

An exposure is considered to be an object finance exposure if it ***involves the acquisition of physical assets*** (including ships, aircraft, satellites, railcars, and fleets) where the ***repayment of the exposure is dependent on the cash flows generated by the specific assets*** that have been financed and pledged or assigned to the lender.

Commodities Finance

An exposure is considered to be commodities finance if it ***involves short-term lending to finance reserves, inventories, or receivables of exchange traded commodities*** (including crude oil, metals, or crops), where the ***exposure will be repaid from the proceeds of the sale of the commodity*** and the obligor has no independent capacity to repay the exposure.

Appendix: Asset Class Definitions (2 of 2)

Income Producing Real Estate (IPRE)

An exposure is considered as IPRE if it ***involves real estate*** (e.g., office buildings to let, retail space, multifamily residential buildings, industrial or warehouse space, hotels) where the ***prospects for repayment and recovery on the exposure depend primarily on the cash flows generated by the asset***

High Volatility Commercial Real Estate (HVCRE)

An HVCRE exposure is a specialised lending exposure ***secured on real estate*** that meets **one or more** of the following criteria:

a. the real estate is bought for ***speculative purposes***;
b. a ***change of planning use*** is sought for the real estate; or
c. loans financing the land, acquisition, development, and construction of real estate where the ***source of repayment at origination*** of the exposure is either:
    i. the ***future uncertain sale of the real estate***; or
    ii. cash flows whose ***source of repayment is substantially uncertain***, unless the borrower has sufficient equity to absorb most losses through the asset development and construction phase in a severe but plausible scenario.

Appendix: Project Finance Specific Definitions

Project Finance Operational Phase

Operational phase means the phase in which the entity that was created to finance the project has:

a. a ***positive net cash flow that is sufficient to cover any remaining contractual obligations*** relating to the completion of the project; and

b. ***declining long-term debt***.

High Quality Project Finance

A project finance exposure is considered to be high quality if the exposure is to an entity that is able to meet its financial commitments in a ***timely manner*** and its ability to do so is assessed to be ***robust against adverse changes*** in the economic cycle and business conditions; and the following conditions are met:

a. the entity is ***restricted from acting to the detriment of the creditors*** (including by not being able to issue additional debt without the consent of existing creditors);

b. the entity has ***sufficient reserve funds*** or other financial arrangements to cover the contingency funding and working capital requirements of the project;

c. the revenues subject to a ***rate-of-return regulation*** or ***take-or-pay contract*** or ***availability-based***, where availability based is,

   i. the entity is entitled to payments from its contractual counterparties once construction is completed, as long as contract conditions are fulfilled;

   ii. the revenues are sized to cover operating and maintenance costs, debt service costs and equity returns as the entity operates the project; and

   iii. the revenues are not subject to swings in demand, and are adjusted only for lack of performance or lack of availability of the asset to the public

d. the entity's revenue ***depends on one main counterparty*** and this main counterparty is central government, a regional government, a local authority, a public sector entity or a corporate entity with a ***risk weight of 80% or lower***;

e. the ***contractual provisions*** governing the exposure to the entity provide for a ***high degree of protection for creditors in case of a default*** of the entity;

f. the main counterparty or other counterparties which similarly comply with the eligibility criteria for the main counterparty will ***protect the creditors from the losses resulting from a termination of the project***;

g. all assets and contracts necessary to operate the project have been ***pledged to the creditors to the extent permitted by applicable law***; and

h. creditors ***may assume control of the entity in case of its default***.

Appendix: Additional Definitions

Substantially Stronger

IPRE exposure can be classified as “substantially stronger” if

a. the transaction is allocated to the ***strong slotting category for each slotting factor***;
b. the ***leverage of the obligor is substantially below the market norm*** for a similarly structured transaction in this sector, region, and of this property location and quality; and
c. a substantial amount of the transaction’s cash flows comes from ***investment grade (or equivalent) counterparties***, with a minimum of 100% of the interest covered by income from investment grade or equivalent tenants.

Preferential Risk Weights Conditions

Firms would only assign the preferential risk weights in the ***strong and good categories*** if the exposure:

a. has ***less than 2.5 years remaining until maturity*** and the firm reasonably considers that the ***obligor could refinance the exposure in a severe but plausible stress*** in the refinancing market; or
b. is an ***IPRE exposure*** and has features which are ***‘substantially stronger’*** than the criteria specified for the ***strong category***.

Who are we

Get in touch with our team of Basel 3.1 credit risk experts

Dr. Lutz Baumgarten

20+ years - M Eng in Engineering Science, M Phil and D Phil in Economics (Oxford)

Vijay Krishnaswamy

20+ years – BSc in Mathematics (Madras), MBA in Finance (Ahmedabad), FRM

Peter Rindfleisch

20 years - MA in Politics, Philosophy & Economics (Oxford), MSc Economics (LSE), First Diploma Economics (LMU)

Raymond Sinclaire CFA, FRM

15+ years – Bachelor's degree Accounting, Master's in Economics (Witwatersrand)

Derek Alston

15 years – CA (SA), B Comm (Hons) in Management Accounting (Witwatersrand)

Christoph Saleh FRM

12+ years – MSc (Frankfurt School of Finance & Management), BA (DHBW Karlsruhe)

Dr. Writam Chakraborty

12+ years – MSc in Applied Mathematics (Jadavpur), PhD in Mathematics (IIEST Shibpur)

Stefanie Rynboom CFA

8+ years – BSc Actuarial Science and Statistics, BSc (Hons) in Advanced Mathematics of Finance (Witwatersrand)

Please reach out to:

- derek.alston@tnp.eu
- stefanie.rynboom@tnp.eu or
- writam.chakraborty@tnp.eu

for any further information or to put you in touch with the rest of the TNP team

True North Partners in a nutshell

Who we are
A unique consulting boutique

Independent LLP in London

- Local staff and subsidiaries in London, Frankfurt, Johannesburg, Madrid, Amsterdam and Dubai
- Founded in 2010 (precursor track record since 2006)
- 14 partners and 100+ permanent staff
- Additional network of senior experts

What sets us apart
A unique consulting approach

A true partner to our clients

- Owner-management for flexibility and long term commitment
- Delivery of real impact, with hands-on senior involvement and oversight

What we do
Excellence in financial services

Deep knowledge of finance, risk and strategy domains

- Risk Management
- Balance Sheet Management
- Finance and Strategy
- Advanced analytics
- Public Sector and Development Finance
- Technologies and tools

TRUE NORTH PARTNERS
FINANCE | RISK | STRATEGY

True North Partners LLP is an independent consulting firm based in London, Frankfurt, Amsterdam, Madrid, Johannesburg and Dubai. We specialise in finance, risk and strategy and have extensive global experience and industry recognition in the financial services, risk management and finance communities.

We have a track record as an independent partnership since 2006. Our clients are leading financial institutions, predominantly in Europe, Middle East and Africa.

Our distinctive value proposition includes three key elements

- Leading practice expertise and experience in risk and finance to develop, tailor and communicate superior solutions
- Strong analytical grounding of our work, be that through financial, economic or statistical modelling
- Hands-on senior involvement and oversight to drive change at our clients, which ensures that we deliver real impact rather than just "PowerPoint concepts"

www.tnp.eu