

## ***Stand out for the right reasons***

### **Financial Services Risk and Regulation**

# ***Hot topic***

## ***Revised standardised approach for credit risk – Enhancing risk sensitivity***

### ***Highlights***

*The revised standardised approach for credit risk is a component of the Basel Committee's outstanding Basel III post-crisis reforms published on 7 December 2017. It considers the revisions improve the regulatory framework's granularity and risk sensitivity together with reducing the mechanistic reliance on credit ratings. It is due to take effect from 1*

The Basel Committee (BCBS) published its outstanding Basel III post-crisis regulatory reforms on 7 December 2017. These reforms include the revised standardised approach to credit risk (SA-CR) and follows the December 2015 consultation. Other parts of the reform package are dealt with in other separate PwC Hot Topics including revisions to the IRB approach for credit risk and the aggregate output floor. The published revision to the SA-CR continues to include the Basel II sovereign risk provisions but this is subject to a separate discussion paper also published by BCBS on 7 December 2017. The reporting implications of these changes is expected to be dealt with in a third phase of revisions to the BCBS Pillar 3 disclosures standard. These outstanding Basel III post-crisis regulatory reforms are due to take effect from 1 January 2022. There are no significant elements in SA-CR subject to any phase-in provisions.

The BCBS intends that these reforms “will help reduce excessive variability in risk-weighted assets and will improve the comparability and transparency of banks’ risk based capital ratios”. It considers the revisions to SA-CR improves the regulatory framework’s granularity and risk sensitivity together with reducing the mechanistic reliance on credit ratings. More specifically it incorporates:

- A more granular approach for unrated exposures to banks and corporates;
- A recalibration of risk weights (RW) for rated exposures;
- Separate treatments for covered bonds, specialised lending and SME exposures;
- A more risk-sensitive approach for real estate exposures based on a loan-to-value ratio (LTV) and recognizing exposures materially dependent on cashflows generated by property;
- More granular RWs for subordinated debt and equity exposures; and
- A recalibration of credit conversion factors (CCF) for off-balance sheet items.

Set out below is a section that outlines the main features of the finalised revised SA-CR followed by a section that summarises the changes made since the December 2015 consultation.

## **Finalised SA-CR**

### **Approaches and categories**

The general approaches for bank, corporate and retail exposures are supplemented by separate treatments for: covered bonds; specialised lending; retail real estate (RRE); commercial real estate (CRE); small and medium-sized enterprises (SME); exposures; off-balance sheet items and subordinated debt and equity exposures. In addition, there is further granularity within both RRE and CRE categories for income-producing exposures as well as land acquisition, development and construction (ADC) exposures. A table that summarises the revised RWs of all the asset categories is set out in the Annex to this Hot Topic.

### **Use of credit-ratings**

The revisions allow the continued use of external credit-ratings for the determination of RWs, termed the External Credit Risk Assessment Approach (ECRA) for the general approaches for bank and corporate exposures. But it also allows jurisdictions to adopt a Standardised Credit Risk Assessment Approach (SCRA) instead that doesn't rely on external credit-ratings. The SCRA incorporates a degree of granularity with three risk grades (A to C) for bank exposures and two risk grades for corporate exposures. For jurisdictions that allow the use of the ECRA, the SCRA also applies for all unrated exposures.

Under the ECRA, but not applying to sovereign or public sector entity exposures, firms must perform due diligence to ensure that the external ratings appropriately and conservatively reflect the credit worthiness of the counterparties. If the due diligence analysis reflects higher risk characteristics than implied by the rating bucket of the exposure, firms must assign a RW at least one bucket higher than the 'base' RW determined by the external rating. BCBS considers that firm should have appropriate systems and controls around these processes and that they should be assessed as part of Pillar 2 supervisory reviews. The finalised SA-CR also removes the option for linking banks' exposure RWs to the sovereign exposure RW of the country of incorporation of those banks.

### **Specialised lending, real estate and SMEs**

Revised SA-CR now has a standalone treatment for specialised lending to corporates that includes project finance, object finance (funding of moveable property eg aircraft) and commodities finance. It allows the use of issue-specific rating where available. For project finance where ratings are not available, differential RWs apply to pre-operational and operational phases as well as operational phase exposures deemed high quality – see change section below.

RRE exposures' RWs are now more risk-sensitive with RWs varying based on six LTV ratio bands. CRE exposures' RWs similarly benefit from an LTV ratio

based approach. Both RREs and CREs treatments separately recognise the higher risk associated with exposures where repayment is materially dependent on cashflows generated by the property securing the loan – termed income-producing real estate (IPRE) exposures.

There is also an alternative loan splitting approach for general RRE and CRE exposures (see change section below), and an additional sub-category, land acquisition, development and construction (ADC) – see change section below.

### **Retail, capital instruments and CCFs**

Retail exposures' RWs are more granular, in particular applying a preferential risk weight to 'transactors' – see change section below. Further, there is now a 1.5 risk multiplier for retail and RRE exposures where the lending currency differs from the borrower's source of income.

In addition, subordinated debt and equity (excluding those deducted from capital instead of risk weighted) is more granular with four classifications compared to a Basel II flat rate of 100% – see change section below.

Off-balance sheet credit conversion factors (CCFs) now apply to unconditionally cancellable credit (UCC) commitments (see change section below) and also the a CCF of 40%, to other credit commitments irrespective of their maturity. Under Basel II < 1 year credit commitments attracted a 20% factor and >1 year commitments a 50% factor.

A specific RW of 85% applies to SME exposures (corporates with consolidated turnover of < €50m). SMEs that also qualify as retail exposures attract a 75% RW.

### **Default, ECAIs, CRM and SFTs**

The definition of defaulted exposures now aligns with the IRB credit risk approach to include other default triggers in addition to the current 90 days past due. RW for exposures in default (excluding RRE exposure that is not IPRE related) are 100% where accounting specific provisions >20% of the outstanding amount of the loan with national supervisory discretion to reduce RW to 50% where specific provisions >50%. Where specific provisions are <20% the RW is 150% – see changes section below.

There are eight criteria that external credit assessment institutions (ECAIs) must satisfy in order for their credit ratings to be recognised by national supervisors for use by firms in the ECRA. There were six under Basel II. The two additional criteria concern abuse of unsolicited ratings and cooperation with national supervisors.

The credit risk mitigation framework's (CRM) simple and comprehensive approaches remain. In line with the approach applied elsewhere in SA-CR the use of external ratings is retained in the CRM but with

alternative provisions applying to jurisdictions that do not allow the use of external ratings for regulatory purposes.

The changes also includes a revised methodology for securities financing transactions (SFTs). This includes the removal of the option of using either a VaR-based approach or a firm's own estimates of volatility to reflect the price volatility of the exposure and collateral for SFTs.

## Changes since the consultation

- Changes since the December 2015 consultation relate RWs of unrated/or not permitted specialised lending reduced from 150% and 120% to 130% and 100% for pre-operational phase project finance and object/ commodity finance respectively;
- RWs of RRE exposures reduced by 5% in most LTV bands with the range of RWs reducing from 25% – 85% to 20% – 70%;
- RWs of income producing qualifying RREs reduced significantly across all six LTV bands eg <50% LTV band RW reduced from 70% to 30% and >100% LTV band reduced from 120% to 105%;
- RWs of income producing CREs exposures reduced across all three LTV bands eg >80% LTV band reduced from 130% to 110%;
- RW of off-balance sheet UCC commitments confirmed – at 10% compared with a provisional 10-20% included in the consultation; and
- RW of off-balance sheet commitments, other than UCC commitments – reduced to 40% compared with a provisional 50%-75% included in the consultation.

## Other changes

The revisions also include a loan-splitting approach for RRE and CRE exposures (and not IPRE or ADC related) as an alternative to the existing whole loan approach. This allows a lower risk RW (20% for RRE and the lower of 60% and RW of counterparty for the CRE) to the proportion of the loan representing up to 55% of the value of the property compared with the remainder of the exposure.

In its consultation, BCBS proposed a RW of 150% for exposures in default (excluding RRE exposure that is not IPRE related) irrespective of levels of accounting provision. The finalised RWs retain the linkage with provisioning levels and represent a partial return to the existing position under Basel II – see Default, ECAIs, CRM and SFT sub-section below.

BCBS also removes the restriction included in the consultation on the using the internal model method (IMM) for calculating the credit equivalent amount for OTC derivatives and SFTs, subject to supervisory

approval – a partial return to the existing position under Basel II.

The credit mitigation provisions now incorporate requirements from a separate November 2015 BCBS consultation – *Haircut floors for non-centrally cleared securities financing transactions*.

mainly to further recalibration of RWs in certain areas, in reducing RWs, and the introduction of additional asset categories (or sub-categories).

## New categories and sub-categories

In addition to the specialised lending and SME exposure categories introduced in the consultation, a new covered bond asset category has also been introduced, covering both issue specific rated assets and unrated assets. To qualify the covered bonds must be subject to 'special public supervision designed to protect bond holders' including collateral arrangements. The underlying assets securing covered bonds are restricted to certain asset classes such as RREs and CREs.

Unrated assets include those rated by an ECAI that the firm's national supervisor doesn't recognise or is rated by an ECAI that the firm has not informed its national supervisor for use in its ECRA. The RW of unrated qualifying covered bonds are related to the RW of the issuing bank, generally 50% of their RW. The new sub-categories introduced are:

- A specialised lending high quality project finance operational phase category – RW of 80% compared with 100% for the remaining project finance operational phase exposures;
- Regulatory retail transactors category – RW of 45% compared with 75% for qualifying retail exposures generally. Transactors are those with credit card and charge card facilities who repay in full at each scheduled repayment date;
- Residential ADC category – RW of 100% compared with 150% flat rate that is now applicable just to ADC exposures to companies and SPVs; and
- Speculative unlisted equity category – RW of 400% and a RW of 100% for equity exposures to certain legislated programmes (national supervisory discretion) and subject to a five year phase-in. This compares to 250% for other equity exposures not deducted from capital.

## Changes to RWs

Changes to the RWs of asset categories include:

- RWs of Grade A and B SCRA bank exposures reduced from 50% and 100% to 40% and 75% respectively, with a further reduction to 30% available for Grade A exposures subject to certain conditions;
- RWs of ECRA BBB exposures to general corporates reduced from 100% to 75% and SCRA corporate investment grade exposures reduced from 75% to 65%;

## *What does this mean for firms?*

- The changes to SA-CR since the December 2015 consultation have softened its impact overall. However the revisions are still likely to have significant impact on certain portfolios, with real estate exposures and specialised finance particularly affected.
- Whilst it is not due for implementation until 2022, market expectations are likely to lead to pressures on firms to disclose the impact of these reforms with increasing degrees of accuracy and granularity required in the run-up to implementation.
- Increased granularity and risk sensitivity inevitably leads to greater operational complexity, likely requiring enhanced systems and controls.
- The SA-CR revisions, together with the changes to the IRB approach and the aggregate output floor change the cost/benefit balance of the standardised versus internal models approaches. So firms may need to re-evaluate which approach is applied to their various portfolios.
- More broadly, taking these outstanding Basel III post-crisis regulatory reforms as whole, the changes should encourage firms to re-examine capital consumption across their business lines as they may potentially need to adjust their pricing and product offerings. The revised framework may well therefore have an impact on firms' strategy and business models. The BCBS expects that the changes will also result in some redistribution of capital in the system.
- Capital floors are likely to be the main focus area for the larger firms, while smaller firms will have to consider particularly carefully what infrastructure and technology enhancements will be needed to handle the increased volume and granularity of data required under the more complex standardised approaches.

## Annex

Summary of risk weights of revised standardised approach to credit risk							
Exposures to banks							
Risk weights in jurisdictions where the ratings approach is permitted							
External rating	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-	Unrated	
Risk weight	20%	30%	50%	100%	150%	As for SCRA below	
<i>Short-term exposures</i>							
Risk weight	20%	20%	20%	50%	150%	As for SCRA below	
Risk weights where the ratings approach is not permitted and for unrated exposures							
Standardised Credit Risk Assessment Approach (SCRA) grades			Grade A	Grade B	Grade C		
Risk weight			40% <sup>1</sup>	75%	150%		
Short-term exposures			20%	50%	150%		
Exposures to covered bonds							
Risk weights for <i>rated</i> covered bonds							
External issue-specific rating	AAA to AA-	A+ to BBB-		BB+ to B-	Below B-		
Risk weight	10%	20%		50%	100%		
Risk weights for <i>unrated</i> covered bonds							
Risk weight of issuing bank	20%	30%	40%	50%	75%	100%	150%
Risk weight	10%	15%	20%	25%	35%	50%	100%
Exposures to general corporates							
Risk weights in jurisdictions where the ratings approach is permitted							
External rating of counterparty	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to BB-	Below BB-	Unrated	
Risk weight	20%	50%	75%	100%	150%	100% or 85% if corporate SME	
Risk weights where rating approach is not permitted							
SCRA grades			Investment grade		All other		
General corporate (non-SME)			65%		100%		
SME general corporate			85% (75% if retail)				
Exposures to project finance, object finance and commodities finance							
Exposure (excluding real estate)		Project finance		Object and commodity finance			
Issue-specific ratings available and permitted		Same as for general corporate (see above)					
Rating not available or not permitted		130% pre-operational phase 100% operational phase 80% operational phase (high quality)		100%			

<sup>1</sup> A risk weight of 30% may be applied if the exposure to the bank satisfies all of the criteria for Grade A classification and in addition the counterparty bank has (i) a CET1 ratio of 14% or above; and (ii) a Tier 1 leverage ratio of 5% or above.

Retail exposures excluding real estate								
	Regulatory retail (non-revolving)			Regulatory retail (revolving)			Other retail	
				Transactors	Revolvers			
Risk weight	75%			45%	75%		100%	
Residential real estate exposures								
LTV bands	<b>Below 50%</b>	<b>50% to 60%</b>	<b>60% to 70%</b>	<b>70% to 80%</b>	<b>80% to 90%</b>	<b>90% to 100</b>	<b>above 100%</b>	<b>Criteria not met</b>
General RRE								
Whole Loan	20%	25%	30%	40%	50%	70%	RW of counterparty	
Loan-splitting approach² RW	20%			RW of counterparty				RW of counterparty
Income-producing residential real estate (IPRRE)								
Whole loan approach RW	30%	35%	45%	60%	75%	105%	150%	
Commercial real estate (CRE) exposures								
General CRE								
Whole loan approach	LTV < 60%			LTV > 60%			Criteria not met	
	Min (60%, RW of counterparty)			RW of counterparty			RW of counterparty	
Loan-splitting approach ²	LTV ≤ 55%			LTV > 55%			Criteria not met	
	Min (60%, RW of counterparty)			RW of counterparty			RW of counterparty	
Income-producing commercial real estate (IPCRE)								
Whole loan approach	LTV≤ 60%		60% < LTV ≤ 80%		LTV > 80%		Criteria not met	
	70%		90%		110%		150%	
Land acquisition, development and construction (ADC) exposures								
Loan to company/ SPV					150%			
Residential ADC loan					100%			
Subordinated debt and equity (excluding amounts deducted)								
	Subordinated debt and capital other than equities		Equity exposures to certain legislated programmes		‘Speculative unlisted equity’		All other equity exposures	
Risk weight	150%		100%		400%		250%	
Credit conversion factors for off-balance sheet exposures								
	UCCs	Commitments, except UCCs	NIFs and RUFs, and certain transaction related contingent items		ST self-liquidating trade letters of credit arising from the movement of goods		Direct credit substitutes and other off balance sheet exposures	
CCF	10%	40%	50%		20%		100%	

<sup>2</sup> Under the loan-splitting approach, a supervisory specified risk weight is applied to the portion of the exposure that is 'below 55% of the property value and the risk weight of the counterparty is applied to the remainder of the exposure. In cases where the criteria are not met, the risk weight of the counterparty is applied to the entire exposure.



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## Stand out for the right reasons



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### *Financial services risk and regulation is an opportunity*

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