BCLP. Client Intelligent

Insights

BASEL 3.1 IMPLEMENTATION IN THE UK AND US

MARKET RESPONSE TO POTENTIALLY ONEROUS UK AND US IMPLEMENTATION PROPOSALS

Dec 01, 2023

SUMMARY

The UK regulators (primarily the Prudential Regulation Authority ("PRA")) are currently reviewing consultation responses received on the proposed implementation of Basel 3.1 in the UK, with the final rules being published between December 2023 and May 2024, and implementation due to start in the UK in July 2025 (pushed back from the original date of 1 January 2025) and finish by 1 January 2030.

On 12 December 2023, the PRA has published the first of two near-final policy statements covering the implementation of the Basel 3.1 standards. This policy statement did not address the real estate lending concerns outlined in this article. The second near-final policy statement is expected in Q2 2024 and is likely to address these.

The US Regulators, i.e. the Federal Reserve, OCC and FDIC, have on 27 July 2023 published their proposals to implement Basel 3.1 (or Basel – Endgame, as it is increasingly referred to in the US) (the “US Proposals”). The consultation period ends on 16 January 2024 with the currently proposed start of implementation being scheduled for July 2025

Some of the proposals have potentially problematic implications for Real Estate Finance (“REF”) and, in turn, the wider UK and US Real Estate market. The US implementation proposal provoked an immediate and robust reaction by the US banks and other key stakeholders in the market.

INTRODUCTION

Bank regulatory capital is a complex and sophisticated area of banking regulation. However, it is also one of the key determinants of the nature and extent of banks’ lending appetite (and the pricing of that lending) across multiple risk profiles in the various financial markets in which they operate.

This article seeks – at a high level – to cut through some of the complexity to highlight some current developments in this area in the UK and the US and their potential impact on the CRE lending markets.

BASEL IN THE UK

The Commercial Real Estate Finance Council Europe (“CREFC”) has submitted its consultation responses to the UK regulators, which focus on 3 key issues arising from the proposed UK implementation of Basel 3.1:

1. The risk weightings proposed by the UK for REF lending are too high, insufficiently risk-sensitive and are incorrectly calibrated (and are more punitive/less risk-sensitive than the Basel 3.1 proposals themselves).

2. Criticism of the flat 150% risk weighting for development and construction financing, and a call for carve-outs to support financing of (a) socio-economic driven RE development (in particular, BTR) and (b) ESG/de-carbonisation of the UK built environment.

3. A requirement for a new (and thus far sketchily outlined) “prudentially conservative” valuation methodology, which could trigger practical gridlock in the CRE market if required to be agreed/implemented/used across the market from July 2025.

One possible result of the current risk-weighting proposals for Basel 3.1 implementation in the UK is the creation of a regulatory environment which, in the medium to longer term, would support alternative lenders taking a greater share of the UK CRE direct lending market (with a correspondingly reduced bank share of that market), but funded by banks as providers of back-leverage finance to such alternative lenders (where such back-leverage finance attracts a lower risk-weighting for bank regulatory capital purposes).

SOME BACKGROUND ON THE BASEL FRAMEWORK AND REGULATORY CAPITAL REQUIREMENTS

BASEL FRAMEWORK

- The “Basel Committee on Banking Supervision” sets the key underlying framework (the so-called “**Basel Framework**”) which guides how regulators across the world determine/implement bank regulatory capital requirements (i.e. capital buffers that banks have to hold to protect themselves in case their assets – in particular, loans - go bad). The committee originally met in Basel, Switzerland, hence the name.

- The original version of the Basel Framework was published in 1988 (known as the “Basel Accord” or “Basel 1”)

- Basel 2 followed in 2004, and Basel 3 (which amended Basel 2) followed in 2010/2011, as a response to the GFC.
- Further regulatory standards followed Basel 3, including Liquidity Coverage Ratio (LCR requirements) and updates to market risk standards following a "Fundamental Review of the Trading Book".
- Further amendments to the Basel 3 Framework (entitled "Finalising post-crisis reforms") were agreed in 2017 and are confusingly referred to in the market as either "Basel 3.1" or "Basel 4" (we will refer to it as Basel 3.1).

This article relates to how the UK is proposing to implement Basel 3.1, which is now due to happen from July 2025 (so less than 2 years' time).

VERY SIMPLIFIED OVERVIEW OF CALCULATION OF REGULATORY CAPITAL REQUIREMENTS

In terms of how bank capital requirements are calculated under the Basel Framework, VERY broadly (as it's a highly complex area), the basic starting point is as follows:

[Amount of lending exposure]	X	8%	X	[Risk weighting (%) for that lending exposure]	=	Amount of capital required to be allocated/set aside in respect of that lending exposure

So the lower the "risk weighting" for a loan exposure, the lower the amount of capital required to be allocated/set aside by the bank in relation to that loan.

The guiding principle (basically reflecting the probability of default) is:

- low risk lending exposures (e.g. to highly rated sovereigns) generally have 0% or very low risk weighting;
- higher risk lending exposures (e.g. lending to poor corporate credits/heavily subordinated lending positions) have a higher risk weighting - anything up to 1,250% (1,250% risk weighting basically means setting aside 100% (1,250% x 8%) of the amount of the lending exposure: i.e. for a £100 loan, the bank has to set aside the full £100).

THREE TYPES OF CALCULATION METHODOLOGIES FOR BANKS TO CALCULATE THEIR CAPITAL REQUIREMENTS:

1. Slotting – larger UK banks only: a procedure where, for regulatory capital purposes, the UK Financial Conduct Authority requires or allows (depending on the type of exposure) financial institutions to assign each of their performing specialised lending exposures one of four risk categories (a slot);

2. Standardised Approach ("SA") – as outlined by the Basel Framework, and used by all but the most sophisticated banks;

3. Internal Ratings Based ("IRB") model – used by the biggest, international and most sophisticated banks (each bank's IRB model is prepared and agreed directly with its regulator).

IRB models tend to be more nuanced/risk-sensitive (based on credit ratings allocated to the relevant assets/exposures) and therefore tend to provide for a lower regulatory capital cost for lower risk lending than would be achieved under the Standardised Approach.

WHY IS THIS RELEVANT TO REAL ESTATE AND REAL ESTATE FINANCE?

Primarily two reasons:

COST OF LENDING

Regulatory capital costs contribute to a bank's funding costs in making a loan, which in turn feeds into the all-in rate at which the bank is able to lend. So if REF loans have a higher "risk weighting", it ultimately makes it more costly for a bank to lend. The UK proposals suggest a higher regulatory capital cost for UK banks in the REF market (compared to banks in jurisdictions which follow the Basel 3.1 recommendations more closely).

TYPE OF LENDING

It may also influence the extent to which banks seek CRE lending exposure via direct REF lending, as opposed to more indirect exposure, such as CRE loan-on-loan financing provided to alternative CRE lenders (which is often "cheaper" from a regulatory capital perspective, because (not being secured directly on real estate) it falls into an entirely different category of lending under the Basel Framework which can carry a lower "risk weighting" for the relevant lending exposures).

With alternative lenders seeking to grow their share of the UK/EU CRE lending market, these developments arguably point, in the medium to longer term, towards an increase in loan-on-loan lending/back-leverage financing in the UK/EU REF market – as a result of higher volumes of debt fund lending and a correspondingly greater demand from such alternative lenders for back-leverage

finance to fund that lending, with banks incentivised to provide that back-leverage financing at a preferable (lower) regulatory capital cost as compared to direct CRE lending.

KEY PROPOSALS OF THE BASEL 3.1 FRAMEWORK RELATING TO REF LENDING

1. Increased risk-sensitivity of "risk weight" thresholds for investment REF lending (i.e. non development/construction REF lending), linked to different LTV levels

Previously (for the Standardised Approach) there was a flat risk weighting of 100% across CRE lending exposures (irrespective of LTV)

Basel 3.1 proposes a more nuanced approach reflecting different lending risk levels at different LTV thresholds:

LTV level	No more than 60%	More than 60% but not more than 80%	More than 80%
Risk weight	70%	90%	110%

2. For land acquisition/development / construction ("ADC") lending

A higher, flat 150% risk weight level is proposed (subject to certain exemptions which reduce this to 100%, such as where the financings have been substantially de-risked through pre-lets/sales). Other than some changes to the detail, this is broadly consistent with current/existing approach.

3. Requirement for a "prudently conservative valuation approach" for the underlying real estate

This has been proposed (A) because of the (new) LTV linkage in the newly proposed "risk weighting" bands for the Standardised Approach, and (B) to counteract the impact of the pro-cyclical nature of property valuations on LTV (and, therefore, risk weight) calculations.

As a result, there is now more of a focus on LTV ratios and, therefore, on the valuations that feed into them.

In very broad terms, adding a little risk sensitivity to the SA risk-weight calculations makes a lot of sense. It is odd (under the current approach) for a very low-risk real estate loan and a very risky one to have the same regulatory capital treatment. Doing that in a way that recognises the property cycle also makes a lot of sense, because the intrinsically pro-cyclical nature of property values makes market value-based LTV a poor risk metric over time.

4. Imposition of a "minimum floor" on the regulatory capital requirement for banks that use an IRB model (i.e. the bigger, more sophisticated banks)

This new rule seeks to reduce the regulatory capital benefit that IRB banks enjoy relative to SA banks, levelling up the minimum capital all banks are required to hold (and reducing the scope for very low risk, very low reg cap, lending in the process).

The rule requires IRB banks to calculate their risk weighted assets ("**RWAs**") in the normal way based on their IRB models, but then to calculate them again using the (revised) SA, so as to compare the two outputs. If the RWA output of the IRB calculation is less than a given percentage (ultimately 72.5%) of the RWA output of the revised SA calculation, the bank has to top up its capital to what would have been required for SA banks.

Importantly, this means that any changes which are made to the collateral valuation methodology (see point 3 above) will impact on **ALL** banks, not just those subject the Standardised Approach – because IRB banks will also need to run a comparative SA regulatory capital calculation as part of the "minimum floor" determination.

UK IMPLEMENTATION PROPOSALS AND CREFC FEEDBACK ON THEM

1. Increased risk-sensitivity of "risk weight" thresholds for investment REF lending

Given the relatively low leverage UK CRE financing market, there is an argument that the Basel 3.1 proposed LTV thresholds (and corresponding risk weights) should actually be revised downwards, to reflect the lower LTV (and therefore lower risk) nature of most of the UK REF market.

However, the UK regulators have gone in the opposite direction:

LTV level	No more than 80%	More than 80%
Risk weight	100%	110%

CREFC feedback: the UK proposed risk weightings for REF lending are too high, insufficiently risk-sensitive and are incorrectly calibrated (and are more punitive/less risk-sensitive than the Basel 3.1 proposals themselves)

It is far from clear why no differentiation is proposed at LTVs below 80%; or why a trivially small extra risk weight of 10% is proposed for LTVs above 80% (rather than a much steeper one to discourage lending at such LTVs)

And with a minimal differentiation in LTV levels between the thresholds, it doesn't really justify the potential market disruption of instigating a new valuation methodology (see further below).

2. Greater policy nuance / risk sensitivity required for the flat 150% risk weighting for ADC lending

The currently proposed approach does not support the financing of policy-driven construction/development real estate projects, such as:

- the “socio-economically important” build-to-rent (BTR) sector; and
- de-carbonising / ESG-driven development.

CREFC urges the UK regulators to consider carve-outs from the current proposals (and alludes to the way US regulators exempt community development projects at sensible leverage levels with a minimum equity investment by the borrower, from their equivalent regulatory capital framework).

3. Requirement for a “prudently conservative valuation approach”

Initially, no-one in the market thought that the language about “prudently conservative” valuation would be interpreted as requiring a departure from the two familiar valuation approaches on which European markets rely (market value everywhere, plus the “mortgage lending value” (MLV) in some markets, notably Germany).

However, first the EU and now the UK have indicated an intention to implement a new “prudently conservative” valuation methodology as written in Basel 3.1 (without, so far, providing more guidance).

The key practical issue arising from these proposals is that the market is not prepared to deliver, in less than two years' time, valuations based on a so far only sketchily defined methodology that differs from market value (and indeed MLV).

CREFC's view: the disruption and friction that would result from the imposition of a new “prudently conservative” approach to property valuation would not be justified.

As referred to above, it is also doubtful whether the very modest LTV-dependent risk weighting variability proposed to be introduced in the UK (see point 1 above) justifies the disruption such a valuation shift would cause.

Potential solutions to this issue could include:

- For market value-based jurisdictions/users, for the relevant supervisory authority to agree with industry (led by the relevant professional body, such as the RICS) clear and simple guidance for how market value valuations need to be adjusted to meet the “prudently conservative” valuation requirement. This adjustment could be as simple/crude as applying a haircut of X% to the market value, but in any case, should be an adjustment that could be easily applied on a consistent basis across the market.
- For Germany, regulatory confirmation that German MLV (as prescribed in German legislation) is consistent with the “prudently conservative” valuation requirement in Basel 3.1 (in reality, it is if anything more conservative).

BASEL IN THE US

KEY US IMPLEMENTATION PROPOSAL RELATING TO REF LENDING

1. Scope of the US proposals

The US Proposals would apply to all US banking organisations with total consolidated assets of $100 billion or more (including Category I, II, III and IV organisations) and to US banking organisations with aggregate trading assets and liabilities exceeding either 10% of their total assets or $5 billion.

The proposals would not apply to any non-US banks or US branches or agencies of non-US banks.

The current proposals would significantly reduce the differences that apply across the four categories of US banks that were created by the US regulations in 2019 (which set the standards for determining the applicability and different levels of stringency of regulatory capital requirements for large banking organizations) and, to an extent, disadvantage US banks from regulatory capital perspective against their non-US competitors.

2. Overhaul of the Risk Weighting Regime

The US Proposals put forward an “Expanded Standardized Approach” (“ESA”), which is based on the currently existing “Standardized Approach”. The ESA would include separate calculations for credit valuation adjustment risk and operational risk, rather than lumping these together as a “general credit risk”.

The ESA uses more granular risk weights in respect of real estate, based on LTV ratio and cash flow. It also sets new risk weights for subordinated debt, investment REF lending and acquisition/development / construction lending exposures.

The US Proposals also look to implement universal “cross default” treatment in relation to bank counterparties (i.e. borrowers), such that exposures to commercial borrowers with any default (on their other loans/ borrowings) will be treated more punitively from a risk-weighting perspective.

The ESA would be used alongside the existing Standardized Approach and the stricter of the two approaches would be applied to determine the capital that needs to be set aside. As such, affected banks will be required to comply with both the ESA and the Standardized Approach, rather than just one regulatory capital model, as is currently the case.

The “Advanced Approach” (akin to the IRB models in the UK) used by the largest, most sophisticated US banks would be disapplied for credit risk. These currently permit a lower risk weights for high-quality REF exposures.

Collectively, these changes are estimated to result in a 16% increase to CET1 [1] capital levels and a 20% increase to RWAs for large bank holding companies, and in higher risk weights for residential real estate (20% higher than the international standards).

[2]

3. Operational Risk and Credit Valuation Adjustment (CVA) Capital Requirements

Under the current regime, only banks using the “Advanced Approach” are required to set aside capital for their operational risk. This is to cover any loss resulting from sub-standard or failed internal processes and systems.

The US Proposals introduce a standardised approach that would be applicable to all large banking organizations and would be based on the bank’s historical losses. The proposed calculation model is stricter than the one contained in the Basel framework.

The US Proposals also intend to extract any CVA related provisions into a standalone risk-based calculation and would not include a tailored approach to commercial end-users (which is the approach generally taken by many other implementing authorities).

The likely effect will be a regulatory cost increase for banks to perform loan servicing, syndication, general advisory work and acting as an agent, advisor.

US MARKET REACTION

- The over 1,150 pages long US Proposals provoked an immediate strong reaction and dissent from US Banks, US legislators and various lobbying groups.
- Jamie Dimon (CEO of JPMorgan) and David Solomon (CEO of Goldman Sachs) have, amongst others, been vocal in their criticism of the US proposals saying that if implemented, the US Proposals risk making banks economically unviable or "un-investable", with the potential to negatively impact economic growth without materially enhancing stability and soundness of the US banking system.
- This has resulted in congressional hearings and in one of the industry’s leading lobby groups announcing an advertising campaign called “Stop Basel Endgame”.
- The US consultation period ends on 16 January 2024 and CREFC US, together with the wider US banking industry, are preparing their (likely robust) submissions, expressing their views on the US Proposals.

CLOSING COMMENT

It is hard to understate the importance of regulatory capital calculations as a driver for the nature and extent of banks’ lending activities across multiple risk profiles. We have provided herein a brief outline of some of the high level principles underlying bank regulatory capital – and the potential impact on such principles of the Basel 3.1 implementation proposals in the UK and the US.

We hope this article provides a useful introduction to some of the key (and current) bank regulatory capital issues as they relate to the CRE/REF market, and we look forward to further engaging with you on this.

FOOTNOTES

[1] Common Equity Tier 1 covers liquid bank holdings such as cash and stock. In the event of a crisis, equity is taken first from Tier 1.

[2] Deloitte_Basel III Endgame_August 2023

RELATED PRACTICE AREAS

- Real Estate Finance
- Finance
- Structured Finance

MEET THE TEAM

William Trotman

London

william.trotman@bclplaw.com
+44 (0) 20 3400 4738

Varuna Bhattacharyya

New York

varuna.bhattacharyya@bclplaw.com
+1 212 541 2196

Nnaemeka Ezeh

London

nnaemeka.ezeh@bclplaw.com
+44 (0) 20 3400 4634

Jan Bervida

London

jan.bervida@bclplaw.com
+44 (0) 20 3400 4017

This material is not comprehensive, is for informational purposes only, and is not legal advice. Your use or receipt of this material does not create an attorney-client relationship between us. If you require legal advice, you should consult an attorney regarding your particular circumstances. The choice of a lawyer is an important decision and should not be based solely upon advertisements. This material may be “Attorney Advertising” under the ethics and professional rules of certain jurisdictions. For advertising purposes, St. Louis, Missouri, is designated BCLP’s principal office and Kathrine Dixon (kathrine.dixon@bclplaw.com) as the responsible attorney.

Cookiebot session tracker icon loaded

© 2024 Bryan Cave Leighton Paisner LLP.