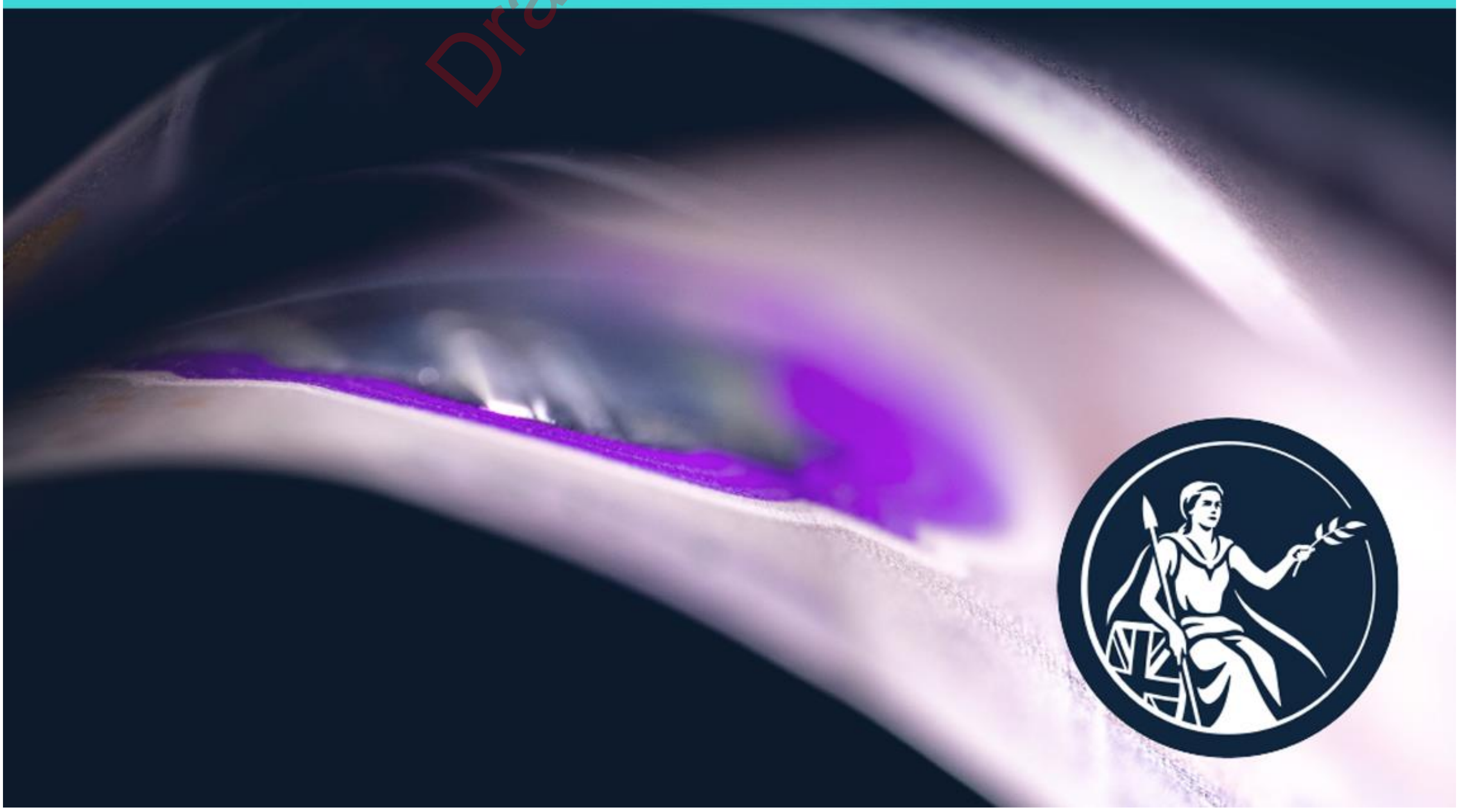
Bank of England

Prudential Regulation Authority

Appendix 11: Draft amendments to SS10/13 – Credit risk: Standardised approach

Consultation Paper | CP16/22

November 2022



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In this appendix, new text is underlined and deleted text is struck through.

…

1 Introduction

1.1 This Supervisory Statement (SS) is aimed at firms to which ~~Capital Requirements Directive IV (CRD IV)~~ the Capital Requirements Regulation (CRR) applies.

1.2 The purpose of this statement is to set out the Prudential Regulation Authority's (PRA's) expectations in respect of certain aspects ~~of a firm's implementation~~ of the standardised approach to credit risk.

2 Exposures to institutions

2.1 The PRA confirms that, in relation to the ~~concessionary~~ treatment set out in Capital Requirement Regulation (CRR) Article 119(5), there are no financial institutions currently authorised and supervised by it — other than those to which the CRR and CRR rules apply~~ies~~ directly — that are subject to prudential requirements that the PRA considers to be comparable in terms of robustness to those applied to institutions under the CRR.

3 Third country equivalence

This chapter has been deleted.

~~3.1 CRR articles 107(3), 114(7), 115(4), 116(5) and 132(3) each include a third country equivalence provision which allows a certain credit risk treatment to be applied where a non-EEA jurisdiction ('third country') applies prudential and supervisory requirements at least equivalent to those applied in the European Union. The Commission is empowered under each of these provisions to make a decision as to which countries apply equivalent arrangements. Prior to the end of 2013, the PRA will set out the approach to be taken during 2014 in the absence of an equivalent determination by the European Commission.~~

3A Exposures to unrated corporates

3.1A Article 122(9) of the Credit Risk: Standardised Approach (CRR) Part of the PRA Rulebook allows a firm using the SA, subject to PRA permission, to assign risk weights that are different to the treatment stated under Article 122(8) of the Credit Risk: Standardised Approach (CRR) Part, to exposures to corporates for which a credit assessment is not available from a nominated eligible credit assessment institution (ECAI) ('unrated corporates'). The PRA will consider granting a permission where a firm demonstrates, to the satisfaction of the PRA, that specified criteria are met. The PRA's expectations in respect of these criteria are outlined below.

3.2A A firm applying for a permission for use of the risk sensitive approach under Article 122(9) of the Credit Risk: Standardised Approach (CRR) Part, must demonstrate, to the satisfaction of the PRA, that it has in place sound, effective and comprehensive strategies, processes, systems, and due diligence practices that enable it to identify and manage its sources of credit and counterparty risk adequately, and therefore enable it to robustly distinguish between investment grade and non-investment grade exposures.

3.3A For the purpose of demonstrating whether a firm has in place sound, effective and comprehensive strategies, processes, systems, and due diligence practices that enable it to identify and manage its sources of credit and counterparty risk adequately, the PRA expects firms to demonstrate that they meet the following non-exhaustive list of factors to the satisfaction of the PRA, including whether:

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- the firm has robust risk management processes, procedures, and controls at subsidiary level and consolidated level, where relevant, to ensure that the use of the permission would not result in inadequate capitalisation of risk due to imprudent allocation of exposures between investment grade and non-investment grade;

- credit and counterparty risk arising from exposures to corporates, where an external rating is not available by a nominated ECAI, has been or will be clearly identified in the internal capital adequacy assessment process (ICAAP) of the firm and will be actively managed;

- allocation of exposures between investment grade and non-investment grade for regulatory purposes is consistent with the firm's own internal risk management systems and is consistent with the firm's due diligence practices; and

- there is an attestation, either from the firm's Internal Audit function or a competent external party, that the firm has sufficient and adequate processes to robustly distinguish between investment and non-investment grade unrated corporates, and to robustly monitor the allocation on an ongoing basis.

3.4A The PRA will make a broader assessment of whether it is appropriate to grant a permission, even where the criteria in Article 122(9) of the Credit Risk: Standardised Approach (CRR) Part are met. In particular, the PRA will consider whether the treatment is consistent with the overall business model of the firm, and furthers the PRA's safety and soundness objective.

Assessment of investment grade unrated corporates

3.5A The PRA expects that an 'investment grade' counterparty should broadly reflect a similar level of creditworthiness and risk as an exposure to a rated counterparty that has a credit assessment by an ECAI that maps to a Credit Quality Step of 1, 2 or 3.

4 Retail exposures

4.1 Where an exposure is denominated in a currency other than ~~the Euro~~Pound Sterling, the PRA expects firms to use appropriate and consistent exchange rates to determine compliance with relevant CRR and CRR rules thresholds.~~[1]~~ Accordingly, the PRA expects a firm to calculate the ~~the Euro~~Pound Sterling equivalent value of the exposure for the purposes of establishing compliance with the aggregate monetary limit of ~~€1 million~~£0.88 million for retail exposures using a set of exchange rates the firm considers to be appropriate. The PRA expects a firm's choice of exchange rate to have no obvious bias and to be derived on the basis of a consistent approach.

5 ~~Exposures fully and completely secured by mortgages on residential property~~Real estate exposures

Exposures that are materially dependent on the cash flows generated by the property

5.A1 The PRA expects that firms should classify exposures as materially dependent on the cash flows generated by the property, where the primary source of cash flows generated by the property securing the exposure would be lease or rental payments.

5.A2 The PRA expects that the material dependence condition would predominantly apply to exposures to corporates, SMEs or special purpose vehicles (SPVs), but is not restricted to those obligor types. As an example, a loan may be considered materially dependent on the cash flows generated by the property if more

~~[1] CRR Article 23(c).~~

than 50% of the income from the borrower used in the bank's assessment of its ability to service the loan is from cash flows generated by the residential or commercial property.

Ijara mortgages

5.1 The PRA considers an Ijara mortgage to be an example of an exposure to a tenant under a property leasing transaction concerning residential real estate exposures ~~property~~ under which the firm is the lessor and the tenant has an option to purchase.

5.2 Accordingly, the PRA expects exposures to Ijara mortgages to be subject to all of the requirements applicable to ~~exposures secured by mortgages on~~ residential real estate exposures, ~~property~~ including in respect of ~~periodic~~ property revaluation.[2]

Buy-to-let mortgages

This section has been deleted.

~~5.3 The United Kingdom has a well-developed and long-established residential property market. For example, in 1987, the amount outstanding of total Sterling net secured lending to individuals and housing associations (not seasonally adjusted) was £166 billion; in 2012, such lending stood at £1.3 trillion.~~[3]

~~5.4 The write-off rate for UK residential mortgages in 2012, calculated using Bank of England data, was 0.05%.~~[4] ~~Pending the availability of annual loss rates collected on a uniform basis through COREP, the PRA considers this write-off rate to be a suitable proxy for the loss rates referred to in CRR Articles 125(3) and 199(3).~~[5]

~~5.5 The write-off rates for the seventeen years prior to 2012 are set out below:~~

- ~~2011 0.06%;~~
- ~~2010 0.08%;~~
- ~~2009 0.13%;~~
- ~~2008 0.07%;~~
- ~~2007 0.03%;~~
- ~~2006 0.03%;~~
- ~~2005 0.01%;~~
- ~~2004 0.00%;~~
- ~~2003 0.02%;~~
- ~~2002 0.01%;~~
- ~~2001 0.03%;~~
- ~~2000 0.04%;~~
- ~~1999 0.07%;~~
- ~~1998 0.08%;~~
- ~~1997 0.15%;~~
- ~~1996 0.11%; and~~
- ~~1995 0.12%.~~

Retirement interest-only (RIO) mortgages

2 Article 124C of the Credit Risk: Standardised Approach (CRR) Part ~~CRR Articles 124 and 125~~
~~3 These data may be found in Bank of England data series LPQVTXH.~~
~~4 The write-off rate was calculated using seasonally unadjusted data extracts from Bank of England series RPATBVX and RPATFHD.~~
~~5 The data have been gathered on the basis of the Bank's reporting form WO which collects data in respect of both complete and partial write-offs as well as write-ons.~~

This section has been deleted.

~~5.6 This section sets out the PRA's expectations in relation to retirement interest-only (RIO) mortgages as well as certain interest-only (IO) mortgages which are converted into RIO mortgages.~~

~~5.7 The PRA expects, at a minimum, that firms should classify conversion of existing exposures to RIO mortgages as being distressed restructuring in cases where (a) the exposure is in default as a result of being a past-term interest only (PTIO) mortgage, or (b) the firm has assessed that the obligor is unlikely to be able to make outstanding principal payments in respect of the exposure.~~

~~5.8 For defaulted IO mortgages to return to non-defaulted status following conversion to an RIO mortgage, the borrower should make a material payment of principal of the IO mortgage such as is necessary to meet the lender's RIO underwriting criteria. In particular, the material payment should be sufficient to reduce the loan to value (LTV) ratio to the maximum at which the lender will offer a RIO product. The payment amount could be zero if the LTV of the RIO mortgage is less than or equal to the level at which the lender will underwrite the product.~~

6 Exposures in default

This chapter has been deleted.

~~6.1 When determining the portion of a past due item that is secured, the PRA expects the secured portion of an exposure covered by a mortgage indemnity product that is eligible for credit risk mitigation purposes under Chapter 4 of the CRR potentially to be capable of qualifying as an eligible guarantee[6].~~

7 Items associated with particularly high risk

This chapter has been deleted.

~~7.1 When determining whether exposures in the form of units or shares in a collective investment undertaking (CIU) are associated with particularly high risk, the PRA expects the following features would be likely to give rise to such risk:~~

~~(a) an absence of external credit assessment of the CIU from an external credit assessment institution (ECAI) recognised under the provisions of Article 132(2) of the CRR, and where the CIU has specific features (such as high levels of leverage or lack of transparency) that prevent it from meeting the eligibility criteria set out in Article 132(3) of the CRR; and~~

~~(b) a substantial element of the CIU's property is made up of items that would be subject to a risk weight of more than 100%, or the mandate of a CIU would permit it to invest in a substantial amount of such items.~~

~~7.2 The PRA would expect a firm's assessment of whether types of exposure referred to in Article 128(3) of the CRR are associated with particularly high risk to include consideration of exposures arising out of a venture capital business — whether the firm itself carries on the venture capital business or not — to be associated with particularly high risk. The PRA considers 'venture capital business' to include the business of carrying on any of the following:~~

~~[6] CRR Article 129(2)~~

~~(a) managing investments which are, arranging (bringing about) transactions in, or making arrangements with a view to transactions in, venture capital investments;~~

~~(b) managing investments in relation to portfolios, or establishing, operating or winding up collective investment schemes, where the portfolios or collective investment schemes (apart from funds awaiting investment) invest only in venture capital investments;~~

~~(c) any custody activities provided in connection with the activities in (a) or (b); and~~

~~(d) any related ancillary activities.~~

8 Mapping of ECAI credit assessments

<u>This chapter has been deleted.</u>

~~8.1 Until such time as the European Commission adopts implementing technical standards drafted by the Joint Committee of the European Supervisory Agencies specifying for all ECAIs the relevant credit assessments of the ECAI that correspond to the credit quality steps set out in the CRR, the PRA expects firms to continue to use **Table 1** for the purposes of mapping the credit assessments of the specified ECAIs to credit quality steps.~~

Table 1 Mapping of ECAIs' credit assessments to credit quality steps for the purposes of the standardised approach

<u>This table has been deleted.</u>

~~Long-term mapping~~

						~~Institution (includes banks)~~			
							~~Credit assessment method~~		
~~Credit quality~~	~~Fitch's-s assessment~~	~~Moody's assessments~~	~~S&P's assessments~~	~~DBRS assessments~~	~~Corporate~~	~~Sovereign method~~	~~Maturity> three months~~	~~Maturity three months~~	~~Sovereign~~
~~1~~	~~AAA to AA-~~	~~Aaa to Aa3~~	~~AAA to AA-~~	~~AAA to AAL~~	~~20%~~	~~20%~~	~~20%~~	~~20%~~	~~0%~~
~~2~~	~~A+ to A-~~	~~A1 to A3~~	~~A+ to A-~~	~~AH to AL~~	~~50%~~	~~50%~~	~~50%~~	~~20%~~	~~20%~~
~~3~~	~~BBB+ to BBB-~~	~~Baa1 to Baa3~~	~~BBB+ to BBB-~~	~~BBBH to BBBL~~	~~100%~~	~~100%~~	~~50%~~	~~20%~~	~~50%~~
~~4~~	~~BB+ to BB-~~	~~Ba1 to Ba3~~	~~BB+ to BB-~~	~~BBH to BBL~~	~~100%~~	~~100%~~	~~100%~~	~~50%~~	~~100%~~
~~5~~	~~B+ to B-~~	~~B1 to B3~~	~~B+ to B-~~	~~BH to BL~~	~~150%~~	~~100%~~	~~100%~~	~~50%~~	~~100%~~
~~6~~	~~CCC+ and below~~	~~Caa1 and below~~	~~CCC+ and below~~	~~CCCH and below~~	~~150%~~	~~150%~~	~~150%~~	~~150%~~	~~150%~~

~~Short-term mapping~~

~~Credit quality step~~	~~Fitch~~	~~Moody's~~	~~S&P~~	~~DBRS~~	~~Risk weights~~
~~1~~	~~F1+, F1~~	~~P-1~~	~~A-1+, A-1~~	~~R-1 (high), R-1 (middle), R-1 (low)~~	~~20%~~
~~2~~	~~F2~~	~~P-2~~	~~A-2~~	~~R-2 (high), R-2 (middle), R-2 (low)~~	~~50%~~
~~3~~	~~F3~~	~~P-3~~	~~A-3~~	~~R-3~~	~~100%~~
~~4~~	~~Below F3~~	~~NP~~	~~B-1, B-2, B-3, C~~	~~R-4, R-5~~	~~150%~~
~~5~~					~~150%~~
~~6~~					~~150%~~

~~Collective investment undertakings (CIUs)~~

~~Credit quality step~~	~~Risk weights~~	~~Fitch~~	~~Moody's~~	~~S&P~~	~~S&P~~
				~~Principal stability funds ratings~~	~~Fund credit quality ratings~~
~~1~~	~~20%~~	~~AAA to AA-~~	~~Aaa to Aa3~~	~~AAAm to AA-m~~	~~AAAf to AA-f~~
~~2~~	~~50%~~	~~A+ to A-~~	~~A1 to A3~~	~~A+m to A-m~~	~~A+f to A-f~~
~~3~~	~~100%~~	~~BBB+ to BBB-~~	~~Baa1 to Baa3~~	~~BBB+m to BBB-m~~	~~BBB+f to BBB-f~~
~~4~~	~~100%~~	~~BB+ to BB-~~	~~Ba1 to Ba3~~	~~BB+m to BB-m~~	~~BB+f to BB-f~~
~~5~~	~~150%~~	~~B+ to B-~~	~~B1 to B3~~	~~B+m to B-m~~	~~B+f to B-f~~
~~6~~	~~150%~~	~~CCC+ and below~~	~~Caa1 and below~~	~~CCC+ m and below~~	~~CCC+f and below~~