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Supervisory Statement | SS10/13

Standardised approach

September 2024

(Updating May 2020)

BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

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1 Introduction

1.1 The purpose of this Supervisory Statement (SS) is to provide clarification to firms of the Prudential Regulation Authority's (PRA) expectations in respect of the standardised approach to credit risk (SA).

1.2 This SS applies to PRA-authorised banks, building societies, PRA-designated investment firms, and PRA-approved or PRA-designated financial or mixed financial holding companies (collectively 'firms').

2 Exposures to institutions

2.1 The PRA confirms that, in relation to the treatment set out in 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 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 [Deleted]

[Deleted]

3A Exposures to unrated corporates

3A.1 Article 122(6) 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 set out in Article 122(5) 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 only grant a permission to use the risk weight treatment set out in Article 122(6) of the Credit Risk: Standardised Approach (CRR) Part where a firm demonstrates, to the satisfaction of the PRA, that the criteria specified in Article 122(6) of the Credit Risk: Standardised Approach (CRR) are met. The PRA's expectations in respect of these criteria are outlined below.

3A.2 A firm applying for a permission for use of the risk weight treatment under Article 122(6) of the Credit Risk: Standardised Approach (CRR) Part must demonstrate, to the satisfaction of the PRA, that it has sound, effective and comprehensive strategies, processes, systems, and risk management practices. These must enable the firm 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 unrated corporate exposures.

3A.3 For the purpose of determining if these requirements are met, the PRA will consider whether:

- 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;

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- credit and counterparty credit risk arising from exposures to corporates where an external rating is not available from a nominated ECAI has been, and will be, clearly identified in the firm's internal capital adequacy assessment process (ICAAP), and will be actively managed;
- the 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 corporate exposures, and to robustly monitor the allocation on an ongoing basis.

3A.4 The PRA will make a broader assessment of whether it is appropriate to grant a permission, even where the criteria in Article 122(6) of the Credit Risk: Standardised Approach (CRR) Part are met. In particular, the PRA will consider whether the proposed treatment is appropriate in the context of the overall business model of the firm, and whether granting the permission would advance the PRA's safety and soundness objective.

Assessment of investment grade unrated corporates

3A.5 The PRA expects that, for the purpose of Article 122(9) of the Credit Risk: Standardised Approach (CRR) Part, an 'investment grade' counterparty should broadly reflect a similar level of credit 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 for the purpose of determining risk weights according to the Credit Risk: Standardised Approach (CRR) Part.

4 Retail exposures

4.1 Where an exposure is denominated in a currency other than sterling, the PRA expects firms to use appropriate and consistent exchange rates to determine compliance with the monetary thresholds set out in the Credit Risk: Standardised Approach (CRR) Part. Accordingly, the PRA expects a firm to use a set of exchange rates that the firm considers to be appropriate to calculate the sterling equivalent value of the total amount owed by an obligor or group of connected clients for the purposes of establishing compliance with the monetary limit of £880,000 for retail exposures referred to in the Credit Risk: Standardised Approach (CRR) Part. 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 over time and across portfolios.

Transactors

4.2 The PRA considers that, where a technical event has occurred, an obligor should not be considered to have failed to repay the balance of a revolving facility, or have drawn down an overdraft facility, for the purpose of the definition of transactor exposure set out in the Glossary Part of the PRA Rulebook.

4.3 For the purpose of paragraph 4.2, a technical event should only be considered to have occurred in the following cases:

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(a) where a firm identifies that the delayed or incomplete repayment, or drawdown of an overdraft facility, was a result of a data or system error of the firm, including manual errors of standardised processes;
(b) where a firm identifies that the delayed or incomplete repayment, or drawdown of an overdraft facility, was a result of the non-execution, defective or late execution of the payment transaction ordered by the obligor, or where there is evidence that the payment was unsuccessful due to the failure of the payment system; and
(c) where, due to the nature of the transaction, there is a time lag between the receipt of the payment by a firm and the allocation of that payment to the relevant account, so that the payment was made on or before the scheduled repayment date (or, for an overdraft facility, on or before the facility was drawn down), but the crediting of the client's account took place after the scheduled repayment date (or, for an overdraft facility, after the facility was drawn down).

5 Real estate exposures

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 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 residential real estate exposures, including in respect of property revaluation.[1]

[Deleted]

[Deleted]

Retirement interest-only (RIO) mortgages

Material previously in this section is now covered in Chapters 3 and 5 of SS3/24 - Definition of default.[2]

Definition of residential real estate

5.9 The PRA expects firms to have a clear documented policy for determining the predominant nature of a property for the purpose of applying the definition of residential real estate set out in Rule 1.2 of the Credit Risk: Standardised Approach (CRR) Part.

5.10 The PRA considers it unlikely that care homes, purpose-built student accommodation and holiday lets would meet the definition of residential real estate set out in Rule 1.2 of the Credit Risk: Standardised Approach (CRR) Part unless the collateral is capable of being resold as a standard residential dwelling in the event of the borrower's default. The PRA expects that property subject to any usage restrictions that would prevent it from being occupied as a residential dwelling on a permanent and continuous basis would not meet the definition of residential real estate.

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[1] Article 124D of the Credit Risk: Standardised Approach (CRR) Part
[2] SS3/24 Credit risk: definition of default

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Mixed real estate exposures

5.11 As set out in Rule 1.2 of the Credit Risk: Standardised Approach (CRR) Part, mixed real estate exposures are non- acquisition, development, and construction (non-ADC) real estate exposures that are secured by both residential and commercial real estate (ie they are not secured by a single property). For the purpose of determining whether each individual property is residential or commercial real estate, firms should assess the predominant nature of the property in accordance with paragraph 5.9.

5.12 For a mixed real estate exposure, firms are required to split the exposure into a residential real estate exposure and a commercial real estate exposure, in accordance with Article 124(4) of the Credit Risk: Standardised Approach (CRR) Part. This should be done in a consistent manner for all elements of the exposure (including off-balance sheet and on-balance sheet elements).To determine the risk weight applied to each part of the exposure, firms should separately consider whether the residential real estate exposure part and the commercial real estate exposure part are deemed to be materially dependent on the cash flows generated by the property.

Examples of the 'loan splitting approach'

5.13 The PRA has set out examples for the calculation of risk weighted assets under the 'loan splitting approach' in accordance with Article 124F and Article 124H(1) and (2) of the Credit Risk: Standardised Approach (CRR) Part below:

(a) Example 1: A loan of £80,000 to a natural person secured on the borrower's primary residence, where the value of the property is £100,000.

To calculate risk weighted assets, the firm would apply a risk weight of 20% to the exposure amount up to 55% of the property value (£55,000) and a risk weight of 75% to the residual exposure of £25,000. This gives total risk weighted assets for the exposure of £29,750 = (20% * £55,000) + (75% * £25,000). The resultant risk weight would be 37.19%.

(b) Example 2: A fully undrawn loan of £80,000 to a natural person secured on the borrower's primary residence (which is located in the UK), where the value of the property is £100,000.

To calculate risk weighted assets, the firm would first calculate the exposure amount up to 55% of the property value that must be assigned a 20% risk weight. The loan is fully undrawn (ie off balance sheet) and secured on a UK property meaning a 50% conversion factor applies. The exposure amount to which the risk weight of 20% is applied is therefore £40,000 (0.50 * £80,000). This gives total risk weighted assets for the exposure of £8,000 (20% * £40,000). The resultant risk weight would be 20%.

(c) Example 3: Where a firm holds a charge and there are charges not held by the firm that rank in priority ahead of the charge that the exposure is secured by ('senior charges'). For example, a loan of £70,000 to a natural person secured on the borrower's primary residence, where the value of the property is £100,000, and there is a senior charge of £10,000 held by another firm.

To determine the part of the firm's exposure that is eligible for the 20% risk weight, the amount up to 55% of the property value must be reduced by the amount of the senior charges not held by the firm.

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In this example, to calculate the risk weighted assets, the firm would reduce the amount of the exposure to which the risk weight of 20% is assigned by £10,000, resulting in the application of a risk weight of 20% being applied to £45,000 of the exposure (instead of £55,000 in the absence of the senior charge) and a risk weight of 75% being applied to the residual exposure of £25,000. This gives total risk weighted assets for the exposure of £27,750 (20% * £45,000) + (75% * £25,000). The resultant risk weight would be 39.64%.

(d) Example 4: Where a firm holds a charge and there are charges held by another firm that rank pari passu with the firm's charge. For example, a loan of £70,000 to a natural person secured on the borrower's primary residence, where the value of the property is £100,000, and there is a charge that ranks pari passu of £10,000 held by another firm.

There are several steps to determine the part of the firm's exposure that is eligible for the 20% risk weight. First, the amount up to 55% of the property value must be reduced by the amount of any charges not held by the firm that rank in priority ahead of the charge that the exposure is secured by. In this example there are no such charges so no such reduction is made. Second, this amount must be reduced by the product of:

(i) the remaining amount up to 55% of the property value after the reduction of any charges not held by the firm that rank in priority ahead of the charge that the exposure is secured by; and

(ii) the amount of charges not held by the firm that rank pari passu with the firm's charge that the exposure is secured by, divided by the sum of all pari passu charges.

The firm would therefore calculate the exposure amount to which the 20% risk weight is assigned as £48,125 ((£55,000-0) – (£55,000-0)*(£10,000/(£10,000+£70,000)). A 75% risk weight is applied to the residual exposure of £21,875. This gives total risk weighted assets for the exposure of £26,031 ((20% * £48,125) + (75% * £21,875)). The resultant risk weight would be 37.19%.

6 [Deleted]

[Deleted]

7 [Deleted]

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8 [Deleted]

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9 Currency mismatch multiplier

9.1 The PRA expects firms to have in place effective internal policies, processes, systems and controls to consider whether the currency mismatch multiplier should be applied to retail and residential real estate

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exposures in accordance with Article 123B of the Credit Risk: Standardised Approach (CRR) Part (including as part of their due diligence processes where applicable).

9.2 The PRA does not consider that it is necessary for firms to request new information from obligors on an ongoing basis to monitor whether a currency mismatch multiplier needs to be applied; however, the PRA expects firms to reassess if there is a currency mismatch for an exposure in each of the following circumstances:

(a) the obligor has provided new information that suggests the currency of their source of income has changed;
(b) the firm has received information that the value of any natural hedges has changed. This includes changes to the value of any assets being counted as a natural hedge; and
(c) the value of any instalment for the exposure has changed.

9.3 For the purpose of determining the currency of the obligor's source of income, the PRA considers that it is generally sufficient for firms to assess whether the obligor's main source of income differs in currency from that of the loan. However, the PRA clarifies its expectations of firms in the following circumstances:

(a) where an obligor's main source of income is in a different currency to the lending currency but other sources of income act as a natural hedge, a firm is not required to consider all sources of income that may constitute a natural hedge for the purpose of determining if an exposure is hedged, provided the assessed natural hedges, together with any financial hedges, cover at least 90% of any instalment for the exposure; and
(b) where the obligor's main source of income is in the same currency as the loan but only covers a small share of the loan repayment amount (when considered alongside any financial hedges), the PRA does not consider that this is sufficient to determine whether the lending currency differs from the currency of the obligor's source of income. Firms should therefore consider an obligor's other sources of income in determining if there is a currency mismatch.

10 Commitments

10.1 To determine the exposure value for off-balance sheet items, firms are required to multiply the applicable conversion factor by the nominal value of the off-balance sheet item (after certain adjustments). The PRA considers that, in the case of commitments, firms need not include any unadvised limit in this nominal value.

11 External Credit Ratings

11.1 For the purpose of risk weighting exposures to institutions, firms must not use an ECAI credit assessment that incorporates assumptions of implicit government support in accordance with Article 138(1)(g) of the Credit Risk: Standardised Approach (CRR) Part.

11.2 Where an ECAI's credit assessment methodology includes considerations of implicit government support, but the ECAI attributes no value for implicit government support in the final credit assessment and has stated this publicly, the PRA considers that the credit assessment should not be treated as incorporating assumptions of implicit government support. Where a firm is using a credit assessment that

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attributes no value to implicit government support, it should have in place robust processes to ensure that it ceases to use the credit assessment if it is updated in a manner that starts assigning value to any implicit government support.

12 Equity exposures

12.1 For the purpose of risk weighting equity exposures, as defined in Article 133(1) to (2) of the Credit Risk: Standardised Approach (CRR) Part, firms are required to measure the age of an undertaking from the date of its establishment, when determining whether an exposure is a higher risk equity exposure in accordance with its definition in the Glossary Part.

12.2 The PRA expects firms to take the date of incorporation for a body corporate or partnership, or the date of the business commencing for an unincorporated association, as the date of establishment of an undertaking, except in the following circumstances:

a) where firms observe that the undertaking has been dormant, through trading inactivity or otherwise, firms should take the date that trading activity first commenced or recommenced as appropriate as the date of establishment; and
b) where an undertaking is not trading, but is otherwise active, such as through the research and development of products, hiring of employees, or other forms of revenue generation, firms should take the date of the first of these events commencing as the date of establishment.

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Annex: Summary of updates to SS10/13

SS10/13 was first published in December 2013. This annex details changes made to this SS following its initial publication.

2024

September 2024

Following PS9/24 – Implementation of the Basel 3.1 standards near-final part 2, the PRA has made the following updates to SS10/13:

- introduced new expectations in chapters 3A and 9 to 12 and paragraphs 4.2, 4.3, 5.9 to 5.13;
- minor amendments to chapters 1 and 2 and paragraph 4.1; and
- removed chapters 3, 6, 7, and 8 and paragraphs 5.3 to 5.8.

These amendments are effective from 1 January 2026.

2020

14 May 2020

Following PS12/20 'Responses to Occasional Consultation Paper 25/19 – Chapter 5: Retirement interest-only mortgages', the PRA introduced new expectations in paragraphs 5.6 to 5.8.

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