Impacts of Basel 3.1 on SME lending and BTL mortgages

Focus on mid-tier banks

Building a better working world

Contents

Introduction

In the UK, the new Basel 3.1 capital reforms will come into effect for banks and building societies from 1 July 2025. These reforms build on previous measures to make the financial system more resilient. The primary objectives of Basel 3.1 include:

1. Improving the reliability of capital ratios by making standardised approaches more risk-sensitive
2. Addressing the limitations of internal models to enhance the accuracy and consistency of capital calculations and limit the benefits of internal models

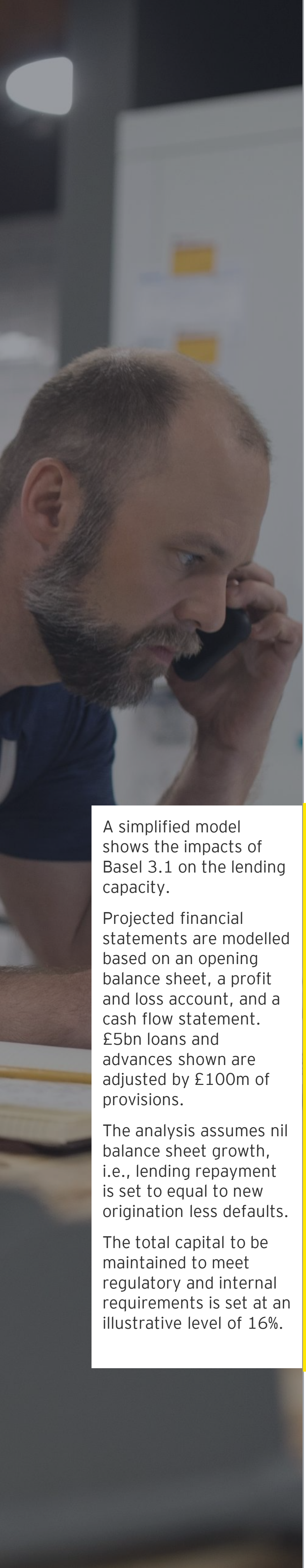
Basel 3.1 is a comprehensive set of requirements that will change the level of capital banks need to hold against the risks associated with their activities.[1] For example, the capital held against the credit risks from different types of lending.

On average, the Prudential Regulation Authority (PRA) estimates that capital requirements for UK banks will increase by around 3% once fully phased in (i.e., in 2030).[2] However, as we will show on the following pages, mid-tier banks are likely to be more disproportionately affected by the proposed changes.[3]

This paper explores the potential impact of the capital reforms on two areas where effective risk weights are being increased: (i) small and medium-sized enterprises (SME) lending and (ii) lending to professional landlords for buy-to-let (BTL) properties.[4] To illustrate the potential impacts of Basel 3.1, we have modelled two hypothetical small banks solely focused on each segment.

The paper focuses on small and mid-tier banks, which tend to be more concentrated on SME and BTL lending than the high street banks. Furthermore, the largest UK banks typically use internal ratings-based (IRB) models for capital. They will benefit from a 4.5-year transition period for Basel 3.1 with a gradual adoption of the "output floor" requirements.

1. The current PRA credit risk proposals set out in CP 16/22 are to be published as near-final rules in Q2 2024.
2. PRA press release regarding implementation of the Basel 3.1 standards
3. Defined as banks with a balance sheet under £50bn that are subject to standardised capital requirements.
4. In the UK, SME lending is defined as lending to 'small to medium-sized enterprises' with fewer than 250 employees and an annual turnover of less than £50m.



Basel 3.1 Impacts: SME lending

According to the OECD, there are approximately six million SMEs in the UK, which contribute 52% of private sector turnover and are responsible for 60% of UK employment.

UK SMEs' primary source of funding is from banks, with the British Business Bank reporting that, in 2023, banks issued a total of £59.2bn of gross lending to SMEs.[5] Of this amount, £34.8bn came from specialist mid-tier banks. Mid-tier banks are now the main providers of SME bank lending, growing their share from c.30% to c.60% over the past decade. In contrast, the five largest banks' share of total gross bank lending to smaller businesses has steadily dropped from c.70% in 2013 to c.40% in 2023.

Basel 3.1 will remove the Retail SME "supporting factor" for the standardised approach, which will have the impact of increasing capital requirements for SME loans.[6] Thus, risk weights will effectively increase from 57% to 75%.

To explore the impact of this change, our first case study focuses on a hypothetical specialist bank (with a £5bn balance sheet) that solely lends to in-scope SMEs:

A simplified model shows the impacts of Basel 3.1 on the lending capacity.

Projected financial statements are modelled based on an opening balance sheet, a profit and loss account, and a cash flow statement. £5bn loans and advances shown are adjusted by £100m of provisions.

The analysis assumes nil balance sheet growth, i.e., lending repayment is set to equal to new origination less defaults.

The total capital to be maintained to meet regulatory and internal requirements is set at an illustrative level of 16%.

Basel workings – Basel 3.1 impact modelling

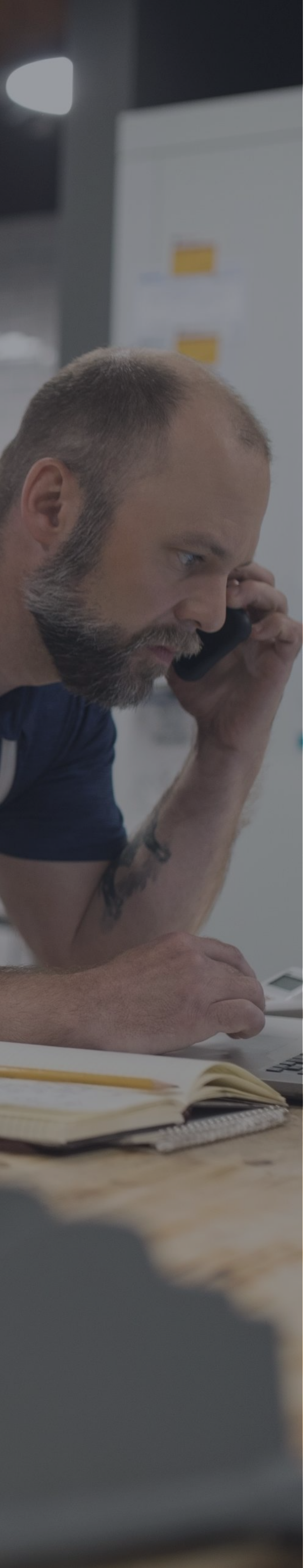
Lending adjustments
(keeping RWA and capital stable)

Assets		*Current*	Basel 3.1
Loans and advances – adjusted	*£bn*	*4.90*	3.72
Total risk weighted assets	*£bn*	*2.79*	2.79
Lending capacity to be forgone	*£bn*	-	*1.18 (-24%)*
Capital requirement after lending adjustments			
Total capital %	*%*	16%	16%
Total capital	*£bn*	0.45	0.45

Capital impact
(keeping lending capacity stable)

Assets			
Loans and advances – stable	*£bn*	4.9	4.9
Total risk weighted assets	*£bn*	2.8	3.6
Increase in RWA	£bn	-	0.8
Capital requirement after RWA adjustments			
Total capital %	%	16%	16%
Total capital	£bn	0.45	0.59
Additional capital required	*£bn*	-	*0.14 (+31%)*

5. Estimates for the proportion of SME funding which is provided by banks varies from c.70% (UK Finance) to c.85% (Bank of England, 2020). SME funding also comes from the non-bank sector.
6. In addition, removal of the SF for Commercial Real Estate which meets the SME SF definition will have a similar effect, with risk-weights moving from 76% (or 85%) to 100% once the SF is removed. Since the financial crisis, Bank lending to SMEs has been supported by the SME Supporting Factor (SF). The SME SF reduced lending costs for banks, resulting in better returns on capital and enabling banks to increase lending.



Our analysis highlights the following potential impacts:

1. **Reduced availability of credit for SMEs:**

With a starting balance sheet of £5bn, a consistent risk and funding profile and a static capital position, the amount of lending our hypothetical bank could support under Basel 3.1 is estimated to be £3.7bn. This represents a 20% to 25% reduction in capacity to lend.

The wider impact on SME credit availability will depend on mid-tier banks' ability and appetite to raise new capital and the extent to which larger banks or non-bank lenders will fill the gap. However, assuming all else equal, if mid-tier banks were to collectively reduce lending to SMEs by 20% to 25%, then bank funding available to SMEs would drop by up to £8bn per year (c.14% of total SME bank funding), equivalent to £40bn of forgone lending over 5 years, throttling an important driver of growth and employment.[7]

Should mid-tier banks want to continue lending at current levels under the Basel 3.1 rules whilst keeping their capital ratios in line with risk appetite, our analysis indicates the sector would need to find c.£3bn. Considering today's market environment, raising this equity is likely to be difficult, with data showing a significant fall in capital funding into UK Fintech in 2023.[8]

2. **Higher borrowing costs for SMEs:**

Regardless of whether lending reduces or mid-tier banks successfully secure additional capital, the cost of funding SME loans will go up under Basel 3.1 since banks will need to hold more capital against lending.

High-level analysis indicates that the changes in requirements could increase funding costs by c.30bps, which would likely be passed on to SME customers.[9] According to the Bank of England (BoE), the effective rate on new loans to SMEs in December 2023 was 7.5%, which would increase to 7.8% under the illustrative uplift. Upward pressure on bank borrowing costs will concern UK SMEs, who have seen the higher interest rate environment increase effective borrowing costs by 160bps over the last year and are experiencing an increase in insolvencies.[10,11]

7. Total stock of outstanding SME lending is c.£175bn: Bank of England, December 2023. Small Business Finance Markets Report 2024 - British Business Bank (british-business-bank.co.uk) pp.15
8. According to the BBB, UK Fintechs raised £615m in the first three quarters of 2023, down 83% on the same period in 2022 - Small Business Finance Markets Report 2024 - British Business Bank (british-business-bank.co.uk) pp.141
9. This assumes a cost of capital of 15% against a cost of deposits of 5%, whereby the bank needs to hold a higher proportion of its balance sheet liabilities as capital against the same stock of SME lending. The cost of capital is taken at the upper end of BoE estimates referenced in a speech by Andrew Bailey, February 2024.
10. Money and Credit - January 2023 | Bank of England. It is noted that the average effective borrowing rate of 5.9% is the highest it has been since 2016. Money and Credit - January 2024 | Bank of England
11. Bank of England Holds Interest Rates Steady as More Companies Fold - The New York Times (nytimes.com)

In our analysis, we have taken a narrow assessment of the impacts of Basel 3.1 on SME lending by a mid-tier bank, focused on high-level impacts on lending, capital requirements and pricing for banks on the standardised approach. However, other potential impacts have been explored in other publications on the subject. For example, we have not considered the impact of Basel 3.1 changes on IRB weightings or the distinction between secured and unsecured loans.[12]

Basel 3.1 impacts: UK buy-to-let

The UK buy-to-let (BTL) sector plays a central role in the provisioning of housing. According to the BoE in its publication The buy-to-let sector and financial stability, the BTL sector provides housing to 45% of private renters. Currently, the BTL sector constitutes around a fifth of the UK mortgage market with £300bn of outstanding mortgage debt. Mid-tier banks provide almost a quarter (22%, £12bn) of all new BTL lending, building societies 15% (£9bn), non-banks 13% (£7bn), and the remaining half (£29bn) come from the largest banks.

Under the current capital regime, all fully secured exposures to residential real estate have a 35% risk weight using the standardised approach, provided the loan-to-value (LTV) of the mortgage is under 80%.

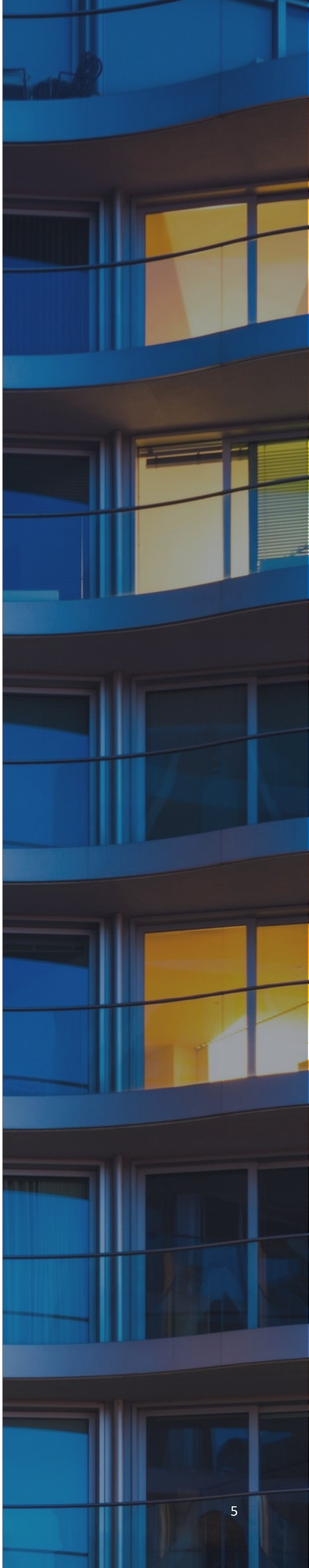
Basel 3.1 introduces a more granular approach to calculating risk weights. As an example, the 35% risk weight is increased to 45% for those exposures deemed to be "materially dependent on the cash flows generated by the property," defined as exposures where a landlord owns four or more properties. This will affect many specialist mid-tier banks, which have actively serviced this section of the market.

To explore the impact of Basel 3.1, we considered a hypothetical specialist bank lending to BTL professional landlords.[13]

Aligned with our approach to SME lending, we have distinguished two scenarios: i) a static CET1 ratio and available capital to consider the impact on available BTL lending, and ii) a static balance sheet whereby the mid-tier bank does not adapt its lending portfolio to calculate the impact this would have on capital requirements.

Similar to our SME lending model, the BTL assumes nil balance sheet growth; lending repayment is set to equal new origination. We assume a spread of lending across different LTV buckets, with the majority of lending (85%) meeting a 60% to 80% LTV threshold, illustrating a representative portfolio.

12. See also the economic analysis conducted by Oxera.
13. All landlords are assumed to own four or more properties and be materially dependent on the cash flows generated by the property



Basel workings – Basel 3.1 impact modelling

Lending adjustments
(keeping RWA and capital stable)

LTV distribution of the portfolio		Current	Basel 3.1
Total assets after lending adjustments (£bn)		**4.90**	**3.98**
LTV <=50%		*0.25*	*0.2*
50%<LTV <=60%		*0.25*	*0.2*
60%<LTV <=70%		*1.96*	*1.59*
70%<LTV <=80%		*2.2*	*1.79*
LTV >80%		*0.25*	*0.2*
Lending capacity to be forgone	*£bn*		*0.92 (-19%)*
Total risk weighted assets		**1.81**	**1.81**
Capital requirement AFTER lending adjustments			
Total capital %	%	16%	16%
Total capital	£bn	0.29	0.29

Capital impact
(keeping lending capacity stable)

		Current	Basel 3.1
Total assets without lending adjustments (£bn)		**4.90**	**4.90**
LTV <=50%		*0.25*	*0.25*
50%<LTV <=60%		*0.25*	*0.25*
60%<LTV <=70%		*1.96*	*1.96*
70%<LTV <=80%		*2.2*	*2.2*
LTV >80%		*0.25*	*0.25*
RWA adjustments			
Total RWA	£bn	1.81	2.23
Increase in RWA	*£bn*	*-*	*0.42 (+23%)*
Capital requirement without lending adjustments			
Total capital %		16%	16%
Total capital	*£bn*	*0.29*	*0.36 (+24%)*

A simplified model shows the impacts of Basel 3.1 on the lending capacity for a BTL lender.

It assumes nil balance sheet growth, i.e. lending repayment is set to equal new origination less defaults.

The model assumes an LTV distribution with 85% of lending in the 60% to 80% LTV bracket, with 10% of lending for an LTV below 60% and 5% of lending for an LTV above 80%.

A blended LTV rate was applied for mortgages with an LTV >80% to reflect the range of risk weights under the current slotting approach and Basel 3.1 risk weights range of 80% to 105% under Basel 3.1.

The total capital to be maintained to meet regulatory and internal requirements is set at an illustrative level of 16%.

The analysis shows that given a typical LTV distribution, a hypothetical mid-tier bank would need to reduce its BTL loans and advances by c.20%. Alternatively, to keep its lending constant, the bank would need to increase its capital position by 20% to 25%.

Across the mid-tier sector, this would translate to a potential reduction in BTL lending by £1.8bn to £2.4bn per year (a 15% to 20% reduction against 2022 lending volumes) or £9bn to £12bn over a five-year period.

Costs of borrowing for BTL mortgages are also expected to increase, but we have not estimated an average rate of increase given how dependent the rates are on the characteristics of each mortgage.

Potential economic impacts

Our analysis of hypothetical SME and BTL banks indicates that Basel 3.1 reforms are expected to reduce the amount of credit extended to SMEs and professional landlords and increase the cost of that lending. However, the precise impacts on the real economy are hard to estimate as multiple forces are at play in these markets that we have not analysed.

1 Reduced bank funding for SMEs and BTL

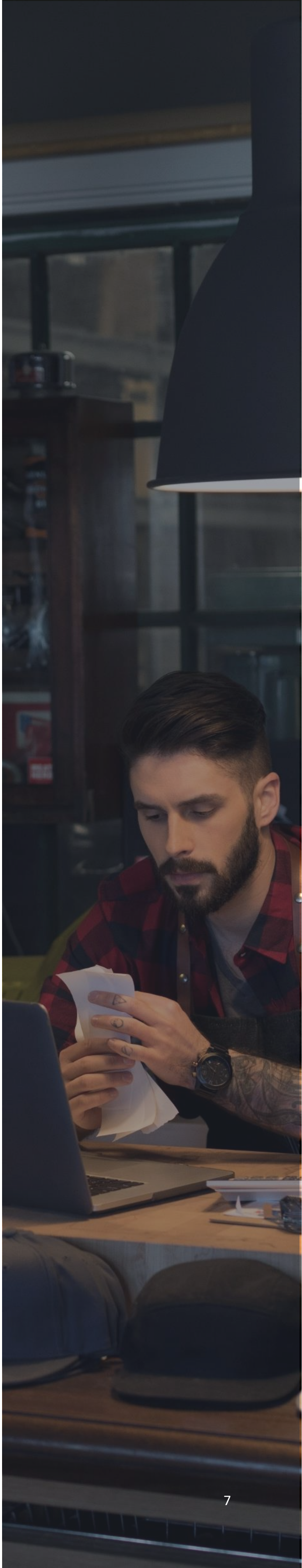
In the absence of any mitigation actions, mid-tier banks will have to reduce lending to SMEs and BTL mortgages to maintain their existing capital ratios. This reduction in lending could amount to up to £40bn for SME lending and £9bn to £12bn for BTL mortgages over the five-year period between 2025 and 2030. Given the relative importance of the mid-tier banks in the provision of this lending in recent years, particularly to SMEs, it is hard to see how this gap will be filled.

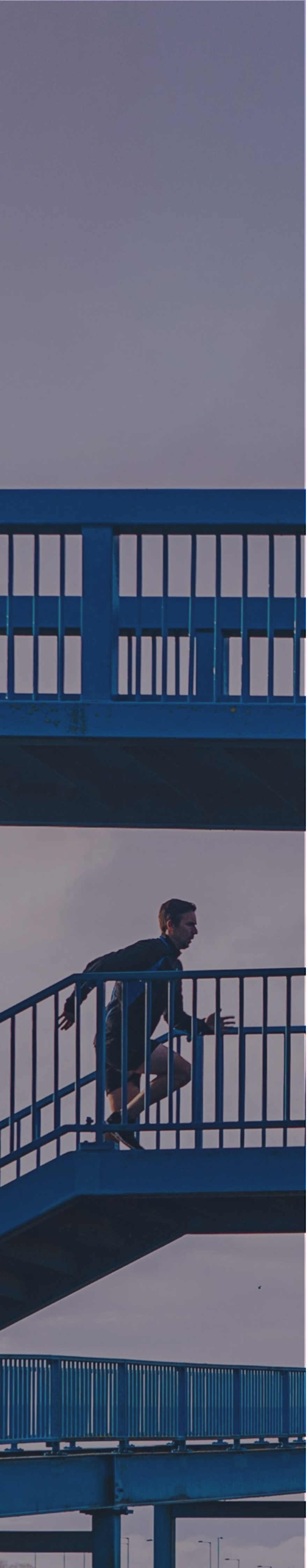
2 More expensive funding for SMEs and landlords

To avoid a sharp reduction in lending, mid-tier banks may seek to raise additional capital (and/or increase retained earnings). The costs of this likely need to be passed (at least in part) onto customers. Increased borrowing costs for SMEs risk constraining businesses critical for the economy and depend on credit to scale and invest. Professional landlords may increase rents or choose to exit the market to the detriment of the supply of rental properties.

3 Market structure impacts

- **Less-viable mid-tier banking segment:** Mid-tier banks may need to absorb some of the additional cost of capital if competitive pressures prevent them from passing on the full costs to customers. This will put pressure on profitability and limit their ability to scale up and compete with the high street banks.
- **Greater use of non-bank lenders:** An unintended consequence might be that the UK sees further increases in lending by non-bank lenders, for example, peer-to-peer lending and private credit institutions, who are not subject to capital requirements. This may impact customers and small businesses as they struggle to access the funding they need at affordable prices.





Challenges for mid-tier banks

As we have seen, under Basel 3.1, from 1 July 2025, the capital requirements associated with portfolios of SME and buy-to-let lending will increase for specialist mid-tier banks.

This introduces a need for many of these banks to reconsider how best to optimise their capital resources and whether they should continue to seek a competitive advantage in these markets or pivot their strategy and business models.

A relevant factor in this assessment is the level of competitive disadvantage the mid-tier banks have compared with the larger high-street banks.

1 Concentration of impacts

Larger banks with more diversified business models can expect to see parts of their loan book attract more capital and other parts less, and therefore have greater opportunity for the positive and negative impacts of Basel 3.1 to be 'smoothed'.

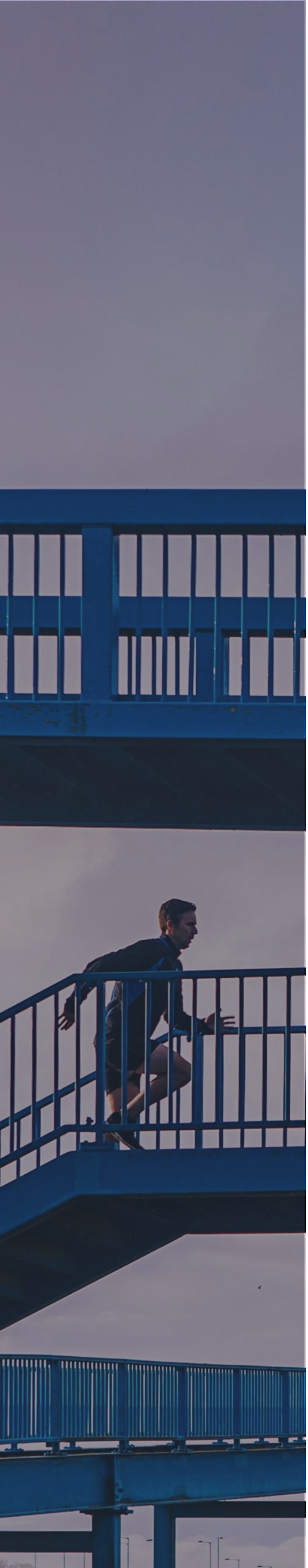
In contrast, specialist mid-tier banks' activity is often concentrated across fewer markets and products. These banks typically operate and invest to grow in segments of the market that were underserved by large banks. As illustrated in relation to the SME and BTL markets, these banks are more vulnerable when risk weights across these activities are increased, and movements in capital requirements can be disproportionately more material as a result.

2 Lack of a transition period

The Basel 3.1 reforms introduce an output floor, which seeks to decrease the disparity between banks using the standardised approach and those approved to use IRB models. However, the relative timing of the new capital rules will maintain the gap between large and smaller banks over the next couple of years.

The large banks, which use modelled approaches to credit risk, effectively have a 4.5-year transitional period before new capital requirements fully come into force. In contrast, the Basel 3.1 reforms impact standardised banks in full from 2025.[14]

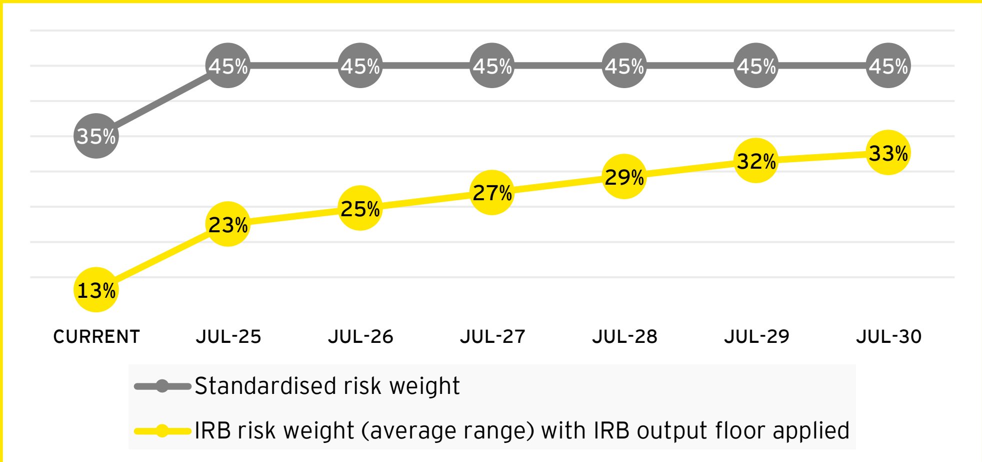
14. The smaller mid-tier banks who adopt the Small Domestic Deposit Takers (SDDT) capital regime can also expect to benefit from delayed onset of new capital requirements via an Interim Capital Regime. PS17/23 – Implementation of the Basel 3.1 standards near-final part 1 | Bank of England. Details of the regime are due to be published in Q2 2024.



The output floor caps the reduction of RWA allowed by models at 72.5%. However, during the transitional period, when the output floor does not apply, the gap persists before the full impact of the floor gradually comes into effect.

This is illustrated below by taking a 60% LTV BTL loan whereby the 22% gap in average risk weights is maintained through 2025 and only gradually results in an improved competitive position.[15,16] In three years, 2027, the gap between standardised and IRB risk weights is estimated to remain comparable to existing levels (c.18 percentage points).

BTL lending – example of changing risk weights



3 Challenging market conditions

The Basel 3.1 rules, affecting the SME and BTL loan portfolios of mid-tier banks, come at a time when these banks are already facing several pressures on capital and funding: economic recession, repayment of the Term Funding Scheme for SMEs (TFMSE) and challenges in obtaining IRB approvals. In addition, capital markets are not in a strong position to fund many mid-tier banks that may need to raise capital at the same time. Finally, the largest mid-tier banks are also required to hold MREL, which comes at a high cost compared with the largest UK banks (see EY analysis on the financial implications of MREL for mid-size and challenger banks).

15. Risk weights apply where landlords own four or more properties and are therefore defined as being materially dependent on the cash flows generated by the property.
16. The current average IRB benchmark is 13.2% and taken from a range provided by the PRA to support Pillar 2A credit risk assessment: Statement of Policy 'The PRA's methodologies for setting Pillar 2 capital' - July 2021 (bankofengland.co.uk).

Conclusions

The mid-tier banks are an integral and important element of the UK SME and BTL lending architecture.

This paper highlights that the proposed Basel 3.1 regulations for SME and BTL lending will likely affect:

I. The availability of credit that mid-tier banks provide SMEs and professional landlords

II. The amount of capital that mid-tier banks will need to raise, or redivert, to achieve planned levels of lending in these segments

III. Pricing for customers

IV. The ability for mid-tier banks to grow and compete with the larger banks

These changes will require banks to adjust their business models and reposition their balance sheets. However, the impact of the Basel 3.1 changes on specialist mid-tier banks that focus on SME and BTL lending will be immediate from the application date of 1 July 2025. This puts them at a disadvantage to the larger IRB banks, as implementing Basel 3.1 does not consider a transition period for the standardised approach.

At Ernst & Young LLP (EY UK), we are already seeing banks examine ways to better manage their capital in anticipation of forthcoming changes. In this regard, we are supporting banks to identify opportunities and execute technical and strategic actions to optimise capital across a number of areas, including:

- Data quality, processes and regulatory interpretations: to ensure banks can efficiently and effectively implement Basel 3.1
- Securitisation, forward flow and risk transfer: strategic capital optimisation options to restructure capital requirements
- Developing and benchmarking robust risk management, capital management and stress testing frameworks: helping firms scale frameworks as they grow.

Contacts

Etienne Michelin
Partner, Financial Stability
UK FSO
Mobile +44 7824 302 426
Email emichelin@uk.ey.com

Claire Jones
Senior Manager, Financial Stability
UK FSO
Mobile +44 7903 110 455
Email cjones4@uk.ey.com

Ian Cosgrove
Partner, Head of Challenger & Specialist Banks, UK FSO
Mobile +44 7715 704 748
Email icosgrove@uk.ey.com

Ben Brown
Partner, Valuation, Modelling & Economics, UK FSO
Mobile +44 7803 016 315
Email bbrown1@uk.ey.com

ED None. EYSCORE 002844-24Gbl

ey.com/uk