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By email to: CP16_22@bankofengland.co.uk.

23 March 2023

Dear Sir/Madam

The IoD is an independent, non-party political organisation representing around 20,000 company directors, senior business leaders, and entrepreneurs. It is the UK's longest-running organisation for professional leaders, having been founded in 1903 and incorporated by Royal Charter in 1906. Its aim is to promote good governance and ensure high levels of skills and integrity among directors of organisations. It campaigns on issues of importance to its members and to the wider business community with the aim of fostering a climate favourable to entrepreneurial activity in the UK.

We therefore welcome the opportunity to respond to PRA Consultation Paper 13/22 on the implementation of the Basel 3.1 standards in the UK.

Introduction

The proposals under consideration are technical in nature. They represent the final stage of implementing the international Basel 3 standards that were developed following the 2007-08 Financial Crisis.

Specifically, they relate to the method of calculating the value of risk-weighted assets held by regulated entities. This value is then used as the denominator for the calculation of regulated capital ratios, so affecting the amount of capital that a bank needs to hold. The higher the value of the risk-weighted asset under the proposed methodology the higher the amount of capital that a bank needs to hold to achieve a given capital ratio.

Our members rely on the health of the business banking sector to conduct their daily operations. We want to see a well-capitalised sector with a robust and well-evidenced approach to risk, that can

provide our members with value-for-money access to finance for investment and working capital purposes as well as day-to-day business banking services. It is therefore also in the interests of our members to have a competitive market for business banking to increase choice and drive down fees.

We have two main concerns about the proposals, which relate to consultation questions 11 and 14.

Withdrawal of the SME support factor (Consultation question 11)

This concern relates to paragraph 3.130 of Consultation Paper 16/22 that proposes to remove the SME support factor.

We oppose the withdrawal of the SME support factor because we are concerned it will lead to less finance available to our members compared to the current situation and that this decision is being taken without an appropriate evidence base for change.

The SME support factor was introduced in 2014 to reduce the potential adverse impact of tighter capital requirements on lending to SMEs with a turnover of less than €50m, applying a variable discount rate of between 15% and 24% determined by the type and total amount borrowed by a specific SME (paragraph 3.134).

The consultation paper suggests that there is limed evidence of the impact of the SME support factor and proposes to abolish it. However, it draws on an EBA paper dated 2016, when the scheme had only been in place for two years (paragraph 3.129).

More recent evidence by Standard and Poor's in 2022, for example, suggests that the impact of the measure is to reduce the difference in financing costs between smaller and larger companies. A literature review conducted as part of a wider report published by Oxera in March 2023 (p.18 onwards) also concludes that the SME support factor has had a positive impact on SME lending and moreover that the current arrangements are appropriate from a prudential perspective. We therefore suggest that the PRA has failed to provide sufficient evidence to justify the removal of the SME support factor.

We recognise that the PRA is separately maintaining the 25% retail risk discount for qualifying SME exposures and is concerned about doubling-up if a lending institution applies both regimes simultaneously. However, given this is currently possible, the removal of the SME support factor will lead to a greater capital requirement for SME lending overall running the risk of reducing the availability of finance for our members. Similarly, while the introduction of a new 15% discount for unrated corporate SME exposures is welcome, by the PRA's own admission "this new concession would not represent a full replacement for the SME support factor" (para 3.134)

Higher risk rating for secured lending to individual businesses (Consultation question 14)

This concern relates to paragraph 3.173 of Consultation Paper 16/22 that contains a proposal for a relatively high-risk weight floor of 100% for any lending secured against commercial property.

We understand the importance of ensuring that any systemic risk in the UK economy arising from potential repricing of commercial property is minimised. The commercial property sector is currently adjusting to the new demands of hybrid working and tighter building regulations at the same time as

interest rates are rising. It is therefore right that the exposure of lending institutions to commercial property assets comes under particular scrutiny.

However this has led to an anomaly in the proposals where lending to a business that is secured against their building is given a higher risk rating than unsecured lending, which may lead to a perverse incentive on lenders to engage in riskier lending.

This issue arises because proposal does not distinguish between the risks of lending for an investment portfolio concentrated in commercial property and the risks of lending to an individual business with that loan secured against a single fixed asset of a physical building that is owned by that business. This is non-sensical and runs the risk of leading to a substantial withdrawal of essential finance for the SME sector, that itself could lead to greater systemic risk.

In addition, as the above-mentioned analysis by Oxera explains (page 24), the proposals are also substantially different from the Basel 3.1 standards that typically allow a risk weighting of between 60% and 85% for loans to SMEs secured against commercial property depending on the precise loan-to-value ratio.

If these two issues are not addressed in the PRA's final decisions, we are concerned that the impact will be a reduction in credit available to our members, with associated impact on levels of investment and so macroeconomic growth, as well as a lessening of competition in the business banking sector that will limit choice and value-for-money without a credible body of evidence of a meaningful reduction in systemic prudential risk.

We hope these reflections are useful

Yours faithfully

Dr Roger Barker
Director of Policy and Governance