UK Basel 3.1 rules:
Large banks will likely welcome the final credit risk rules

HOT TOPIC

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Highlights

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Summary of the final rules

On 12 September 2024, the Prudential Regulation Authority (PRA) published Policy Statement PS 9/24 setting out the final UK rules on credit risk and the output floor to implement the post crisis Basel Committee on Banking Supervision (BCBS) reforms, "Basel 3.1". The implementation deadline is now 1 January 2026 - a delay of six months from the proposals.

The PRA estimates that the Tier 1 capital requirements of major UK firms will be virtually unchanged by the final rules, with an aggregate increase of less than 1% when the rules are fully phased in. Firms will need to assess the impact for their own business model, portfolio and products as average impacts can be misleading.

The PRA has tailored the final rules to reflect its secondary competitiveness objective and its view of certain risks but, overall, the final rules are materially aligned with the BCBS standards, with less divergence than the EU.

Key highlights

Most of the rules are finalised in line with the consultation but there are some welcome changes which reduce over-conservatism and address operational implementation issues in certain targeted areas.

In the standardised approach to credit risk, the PRA has retained the more risk sensitive approach for **unrated corporates** and funds, which will be welcomed by large UK banks and remains a divergence from BCBS and EU.

The **CRR support factor** for Small and Medium Enterprises (SMEs) and infrastructure lending will be removed from Pillar 1. However, there will be a **structural adjustment in Pillar 2A** to mitigate some of the impact. This is more likely to benefit large firms with other Pillar 2A add-ons to offset. Practical elements of the application of this offset (and whether it will provide substantive capital relief) remain unclear.

The 100% risk weight floor for **commercial real estate** which is not materially dependent on cash-flows from the property has been removed.

There are several helpful clarifications to **mortgage lending valuations**. Notably, the PRA has maintained the use of loan-to-value (LTV) at origination but they have introduced a backstop to update the value every 5 years.

More fundamentally, the PRA has clarified that the use of Automated Valuation Models (AVMs) will continue to be permitted.

The credit conversion factors (CCFs) for **off-balance sheet** exposures have been amended with a preferential 20% CCF for transaction-related contingent items (e.g. trade finance exposures); a 50% CCF for UK residential mortgage pipeline and a lower 40% CCF for 'other commitments'.

Under the IRB approach, the PRA has re-based the calculation of immaterial exposures for **roll-out** to be more proportionate, and have provided clarity on the **pathway for model change** in light of the near-final rules.

Furthermore, the PRA has clarified that **undocumented forms of support** could be used to adjust obligor grades which will be welcomed by large UK banks. A number of changes have also been made to the **specialised lending** framework.

The **output floor** is broadly in line with the proposals, but with a technical fix for accounting provisions and a shorter transitional period ending 2030.

As set out in CP7/24 – The simplified capital regime for Small Domestic Deposit Takers (SDDTs) will use the Basel 3.1 rules as the basis for the SDDT capital regime.

The final rules on market, counterparty and operational risk were published in 2023.

Credit Risk - Standardised Approach

The proposals included a number of changes to the standardised approach (SA) for credit risk which would have had a significant impact on the RWAs of UK CRR firms. In the final rules there are some welcome changes and clarifications which are likely to reduce the overall capital requirements for firms when compared to the proposals.

Exposures to individuals and SMEs

The PRA has retained a significant number of its proposals in this area including (a) the removal of the CRR SME support factor under Pillar 1; (b) the introduction of a new 85% preferential risk weight for exposures to unrated corporate SMEs; (c) the retention of existing 75% risk weight for exposures to qualifying retail SMEs; and (d) the introduction of a new 45% risk weight for retail SME transactor exposures.

However, in response to significant concerns over the impact of the proposals on the availability of SME lending, the PRA has introduced further changes:

- A firm-specific structural adjustment to Pillar 2A (the 'SME lending adjustment')
- A revised SME definition which will allow more exposures to benefit from the lower SME risk weights.
- The current requirement on firms to undertake a bespoke assessment to identify other obligors of the firm that may be connected to the SME is no longer required.
- Removal of the commercial real estate floor for certain exposures (see the real estate section).

Exposures to corporates and infrastructure lending

The PRA has not changed its proposed approach to risk weights for unrated corporates where 65% is applied to investment grade exposures and 135% to non-investment grade exposures. This remains an important area of international divergence, with the UK, US and EU applying different approaches. For large UK banks with predominantly investment grade exposures, the 65% risk weight is beneficial and may have a significant marginal effect on whether the Output Floor is binding.

The PRA will remove the infrastructure supporting factor but, in a similar approach to SME lending, the PRA will introduce a firm-specific Pillar 2A structural adjustment for infrastructure lending to ensure overall capital requirements are not increased. The final rules also extend the scope of 'high quality' unrated project finance (i.e. infrastructure lending) exposures that could qualify for a lower 80% risk weight.

Exposures to institutions and covered bonds

The PRA has maintained its proposed Standardised Credit Risk Assessment Approach (SCRA) for unrated institutions, under which the risk weight for short-term unrated exposures with an original maturity of three months or less could range from 20% to 150%, compared to 20% under the CRR. The proposed changes to the risk weights for exposures to rated institutions have also been maintained.

For exposures to eligible unrated covered bonds, the most notable change is the removal of the PRA's proposed requirement for real estate collateral in eligible covered bond pools to be revalued at default.

External credit ratings and due diligence

The PRA maintains its requirement for firms to perform their own due diligence of obligor credit quality and to amend risk weights where the due diligence indicates higher risk than the external rating. The PRA has clarified that 0% risk-weighted multilateral development banks and international organisations will be exempt from this requirement.

The PRA maintains the proposal that banks cannot use external ratings that assume implicit government support.

Residential and commercial mortgages

Under the final rules, regulatory real estate exposure risk weights will be determined based on property type, the LTV ratio and whether repayments are 'materially dependent on the cash flows generated by the property'. There are several changes that will be welcomed by firms in the final rules.

The biggest change from the proposals is for lending secured on commercial premises. The PRA has removed the 100% risk weight floor for exposures secured by commercial real estate (CRE), where repayment is not 'materially dependent on cashflows from the property' and where the exposure meets the 'regulatory real estate (RRE)' definition. This means that under the new rules, in some cases, firms can benefit from risk weights as low as 60% for commercial real estate depending on the LTV profile of the loans and the counterparty type. Notably, SMEs will benefit from preferential risk weights relative to non-SME corporates.

The PRA had previously classified care homes, purpose-built student accommodations and holiday lets as commercial real estate, which was a source of consternation for a number of mid-tier banks. The PRA has removed these explicit classifications from the final rules but has, instead, published guidance (via SS 10/13) that require that the property is capable of being resold as a 'standard residential dwelling' in the event of repossession. The PRA has also allowed "self-build" mortgages to be treated as regulatory residential real estate - and eligible for the lower risk weights - which will come as a relief to building societies. In another positive move for the industry, the PRA will allow second charge mortgages to be classified as RRE, but again, subject to conditions that firms will need to carefully assess.

Overall, the final rules on revaluation of real estate are more risk-sensitive and will be operationally simpler to implement. While firms must still use the valuation at origination, there is a new backstop revaluation requirement which may be applied after five years. The PRA has removed the requirement for firms to adjust valuation to reflect the 'prudent value' of the property that would be sustainable over the life of the loan; and simplified the downward revaluation requirements, by requiring firms to revalue properties if they estimate that the market value of the property has decreased by more than 10%. The PRA has also clarified that valuations can be provided by a suitably robust statistical model, which could include an automated valuation model.

Finally, the PRA previously proposed that houses in multiple occupation (HMO) should be treated as 'materially dependent on the cash flows generated by the property', while explicitly carving out exposures to individuals with three or less mortgaged residential properties in total across all lenders (excluding the primary residence). Under the final rules, firms will have greater latitude to assess HMOs in the same way as other residential real estate exposures.

Off-balance sheet exposures

There are two material but positive departures from the PRA's previous proposals. First, the PRA is introducing a 40% Credit Conversion Factor (CCF) for 'other commitments' (subject to certain exceptions). This is a reduction from the 50% CCF proposed. While this will align the UK more closely to the Basel standards, a 50% CCF (instead of Basel's 40% CCF) will still be retained for UK residential mortgage commitments (which the PRA stated is justified based on UK mortgage data). Second, transaction-related contingent items (which will most often be trade finance) will benefit from a 20% CCF instead of the proposed 50% CCF.

The PRA has maintained its proposed definition of a 'commitment' and has not exercised the 0% CCF national discretion for unconditionally cancellable commitments for certain corporates and SME exposures, which has been adopted in the EU.

Capital instruments and defaulted exposures

The PRA has maintained its proposed risk weight treatment for equity exposures (250% or 400%). The most material change is the clarification that the 400% risk weight shall be applied to 'higher risk' equity exposures, which is a change from 'venture capital' exposures in its proposal. The definition of 'higher risk' equity exposures has been calibrated against the age of a business (i.e. less than five years old) to address industry's concern on the ability to consistently define 'venture capital' exposures and following additional data review by the PRA.

The risk weight treatment of subordinated debt (150%) and other capital instruments will also be implemented as proposed.

On defaulted exposures, apart from a technical clarification that only defaulted residential real estate exposures that are 'not materially dependent on the cash-flows of the property' can be eligible for the flat 100% risk weight treatment, the PRA will implement the risk weights for other defaulted exposures (100% or 150%, depending on provisioning level) as proposed.

Credit Risk - Internal Ratings Based (IRB) Approach

The PRA's original proposals broadly aligned with the Basel standards and were intended to reduce the complexity of the approaches and improve comparability across firms. However, the PRA has chosen to apply a more conservative or 'super-equivalent' approach in a few areas, including restricting the use of IRB for some exposure classes (eg sovereigns) where BCBS was unable to reach consensus. In the final rules, adjustments have been made to a number of areas of the framework where concerns were raised on operational complexity of implementation.

Scope of IRB permissions

The PRA has provided helpful clarifications over a number of practical elements of the IRB Permission process. Essentially, all changes to IRB Permissions resulting from the restrictions on the use of the IRB approach (see below) will be amended by the PRA. Given historical challenges, where model permissions did not align with implementation, firms should ensure that the revised IRB Permissions are accurate and consistent with their implementation of the standards. For new and in flight applications, firms should liaise with their supervisory teams to agree the glide path to approvals, with due consideration for the requirement for 'material compliance' under the final rules instead of the 'full compliance' under the CRR. This affords the PRA greater flexibility to approve these models. By allowing firms to make (or revise) an application "under the near-final rules", the PRA may have found an elegant solution to model approval issues.

Furthemore, the PRA has also clarified that materially non-compliant IRB model change applications would be approved for existing IRB firms - where the approval would reduce the overall level of IRB non-compliance and the firm has a credible remediation plan in place. This will bring the UK approach closer to the conditional model approval approach in the EU and will be a welcome change for firms.

Roll-out and permanent partial use

Following feedback from firms on the operational burden of building models for "material" exposures in relatively small roll-out classes, the PRA has revised the materiality assessment to be a cumulative threshold across all roll-out classes for which a firm has permission to use the IRB approach. This represents a proportionate outcome that continues to minimise cherry-picking across exposure classes and within a roll-out class.

Proposals to keep specialised lending and qualifying revolving retail exposures roll-out classes under IRB have been retained, but need to be read in the context of wider changes to the materiality assessment.

Restrictions on using the IRB approach

The use of the IRB approach had previously been restricted for central governments and central banks - this has now been extended to include all quasi-sovereigns following concerns raised over the inextricable overlap between the models used for sovereign and quasi-sovereign exposures. Whilst reducing operational complexity from a UK standpoint, this approach represents a fundamental departure in the delineation between the central government and institution exposure classes under the CRR and will likely also result in lower RWAs in the round. The PRA, therefore, has proposed to consider this as part of its proposed adjustments to the Pillar 2 framework.

Consistent with the BCBS standard, for exposures to institutions, financial corporates and large corporates, firms will have to use either Foundation IRB (F-IRB) or SA to calculate their RWAs. Consistent with the approach under current rules, firms should also estimate effective maturity under F-IRB. The slotting approach remains the only option under IRB for the Income Producing Real Estate (IPRE) and High Volatility Commercial Real Estate (HVCRE) exposure classes.

Exposure classification

The PRA has reversed its proposals to include undrawn commitments in the assessment of SMEs against the proposed £0.88m threshold and instead only require firms to consider 'total amount owed'. This brings the proposals back in line with current practices and the definition of retail SMEs under the revised SA rules, whilst being different from the final Basel rules. This will be a significant relief for the industry who had concerns about retail SME exposures being reclassified into the corporate exposure class and having to develop a new suite of models for this segment.

Following concerns raised on the broad definition of HVCRE, the PRA has also updated the definition to ensure residential developments are not inadvertently captured under this definition and has broadly aligned the definition to the BCBS standard.

Input floors

The PRA has maintained input floors that generally align with BCBS standards, except for the UK residential mortgages portfolio where a more conservative probability of default (PD) floor of 0.1% is applied. A 0.05% PD floor has been adopted for all other exposure types. The LGD floors in the final rules are generally consistent with the Basel standards: ranging from 5% for residential mortgages (with some clarifications on the scope in this space) and between 25-50% for other unsecured and retail exposures.

The PRA has maintained a dual approach to calculate the exposure at default (EAD) input floor: where a firm calculates own estimates of CCFs for revolving commitments, these CCF estimates would be floored at 50% of the SA CCF; and where a firm calculates own estimates of EAD, estimates would be floored at the current balance plus 50% of the F-IRB CCF multiplied by the nominal balance of the undrawn exposure (with a broader accounting value floor applied).

Parameter estimation and supervisory factors

In alignment with the Basel standards, the PRA has finalised a number of changes to model parameter estimation requirements to reduce variability in RWAs.

PD estimation

A critical element of the PD estimation framework is the prohibition of continuous scales in PD models which is expected to be a significant challenge given the prevalence of these, especially in retail modelling. Whilst not making any changes to this requirement, the PRA has clarified that its views on rating and calibration philosophy have not changed, therefore confirming a “point-in-time plus buffer” approach and dynamic recalibration for non-mortgage retail models to be appropriate.

Furthermore, the PRA has retained the requirement for firms to consider ‘seasoning’ effects as a PD risk driver for retail exposures - the regulation has been clarified to potentially consider these adjustments through a margin of conservatism (MoC), if needed.

Finally - and as a welcome relief to the industry - the PRA has softened its position on the use of undocumented forms of support (e.g. parental support arrangements). Firms can continue to make obligor grade adjustments where undocumented support is available, subject to risk management requirements set out in SS4/24 (the “new” SS11/13 - Credit risk internal ratings based approach) being met. The notching approach for subsidiaries - also ubiquitous across the market - will be permitted with a requirement that individual entities have a standalone rating.

LGD estimation

Under A-IRB, the PRA had proposed that the recoveries from ineligible collateral are not considered for the purposes of calculating LGDs, and firms should instead calculate an ‘unsecured LGD’ for such exposures. New expectations have been introduced on firms’ policies on the treatment and allocation of unidentified cash flows that result in a conservative outcome from an LGD estimation standpoint. This may present a key issue from an LGD modelling standpoint as historically, firms may not have formally documented their sources of recoveries and this information will be difficult to establish retrospectively from a modelling standpoint - conservative adjustments to recoveries will need to be considered in the absence of this.

EAD estimation

From our discussions with the industry, there appeared to be some confusion over the PRA’s proposals over EAD estimation in particular the scope of EAD models. The PRA has reaffirmed that it is restricting the scope of EAD modelling to revolving commitments in the form of revolving loan facilities only.

Furthermore, the PRA has also ensured that the definition of a ‘commitment’ is consistent across SA and IRB under the near-final rules and removed references to certain circumstances under the IRB approach where firms need not estimate an EAD / CCF for certain exposures.

The treatment of unadvised limits in the context of EAD estimation and CCF modelling has also been clarified. Only advised limits are expected to be considered for the purposes of CCF modelling. However, total balance at default should be considered in the realised EAD / CCF and estimated EAD / CCF calculations.

Other core elements of the framework

Consistent with the CP, the PRA has proposed to extend the 1.25 asset value correlation multiplier to all large financial sector entities (FSEs), regardless of the status of their prudential regulation, and to amend the unregulated financial sector entity definition to all financial sector entities that are not prudentially regulated banks, investment firms and insurers. The PRA has also proposed to amend the threshold for a large FSE to include the total assets of the entire group and redenominate the threshold to £79 billion ($100 billion in the Basel standards).

Furthermore, the PRA has made a number of changes to the framework for specialised lending. Salient amendments include:

- revisions to the definition of HVCRE (as noted earlier);
- removal of the restrictions over the application of lower risk weights based on maturity to exposures not subject to refinancing risk
- adjustments to the beneficial treatment for ‘substantially stronger’ IPRE exposures; and
- introduction of a ‘substantially stronger’ Project Finance category.

Credit Risk Mitigation (CRM)

The PRA final rules broadly align with Basel in most areas including removing certain methods of Funded Credit Protection (FCP) under the SA, amending the F-IRB calculation and introducing a new method for A-IRB firms that lack data. For Unfunded Credit Protection (UFCP) they introduce restrictions on recognising and modelling CRM and restrict where PDs may be adjusted.

However, there are instances where the PRA has clarified ambiguity in Basel standards and have introduced proposals which are not strictly aligned.

CRM approaches and methods

PRA has amended the rules on recognising the CRM on guarantees, or other unfunded credit protection, which are secured with financial collateral. There is a decision tree which clarifies the treatment of ineligible protection providers and cases where the benefit of both the financial collateral and the guarantee can be recognised.

The PRA had previously proposed that collateral would not be recognised in the CRM framework for exposures subject to the slotting approach (eg specialised lending). Instead, collateral would be reflected in the assignment to slotting categories and the respective risk weights. The PRA has acknowledged that this is too conservative in some cases, and has modified the rules to allow firms to recognise collateral in the calculation of the exposure value and then apply the standard slotting risk weights to the reduced exposure value.

Real estate

The PRA has amended the final rules so that firms using the foundation collateral method to value immovable property should first reduce the value of exposure by the applicable haircuts and then allocate to the charges in order of priority. This ensures that the foundation collateral method and the SA approach will be consistent.

The CP16/22 consultation raised a number of questions on the use of automated valuation processes for real estate exposures. The PRA has clarified that valuations can be provided by a suitably robust statistical model, which could include an automated valuation model.

Securities Financing Transactions (SFTs)

Under UK CRR Art 299, firms may recognise a wider range of collateral for repurchase transactions and securities or commodities lending or borrowing transactions in the trading book. The PRA has amended the final rules to clarify that the collateral does not have to be in the trading book but that additional criteria must be met to be eligible. Firms must: (i) assess the market liquidity of securities; (ii) have the legal and operational capabilities to trade the instruments; and (iii) have the capability to risk manage and value the instruments within the trading book.

Notably, only “margin lending transactions” with legal transfer of title are eligible for the wider recognition of trading book collateral. Transactions where title is not transferred would not be eligible due to the longer time it would take to liquidate the collateral.

The PRA has made minor modifications to the revised formula to recognise financial collateral for Master Netting Agreements across multiple securities financing transactions.

The final rules do not include the minimum haircut floors for securities financing transactions that were included in the BCBS standards. With the EU and US deciding not to adopt these rules, this will be a welcome omission for firms. However, policy-makers have signalled that they may come back to this topic with revised proposals in future.

Collateral eligibility

There are a number of amendments that affect the eligibility of collateral.

The PRA set an expectation that any financial collateral asset that has a material positive correlation with the total value of all the assets to which a lender has legal recourse is not considered eligible collateral. To reflect feedback from firms, PRA has introduced a transaction-specific carve-out in Supervisory Statement SS17/13 for transactions like sold covered call options - where the exposure value is a function of the collateral value.

PRA has clarified that only equities or convertible bonds **listed** on a recognised exchange are eligible under FCCM, instead of the previous, broader, definition which referred to **traded** securities.

There are also changes in respect of the recognition of Collective Investment Undertaking (CIU) collateral to improve the recognition of CIUs. This includes clarifications of the approaches to be applied where firms use the look through or mandate based approaches.

Unfunded credit protection (UFCP)

Unfunded credit protection includes guarantees, credit insurance, credit derivatives and similar arrangements.

The PRA has maintained its proposed approach that under the risk weight substitution method firms would substitute the risk weight of the exposure with that of the protection provider as calculated under the SA, even if direct exposures to the protection provider are risk weighted under the IRB approach. Industry responses were concerned that this affected the ability of firms to take account of parental guarantees which is an important risk management approach. The PRA maintained its proposal to be consistent with the BCBS standards and to maintain consistency between SA and IRB firms.

The PRA proposed to introduce an additional provision that UFCP would only be eligible if it does not contain any clause which would allow the protection provider to change the credit protection unilaterally to the detriment of the lender. The PRA has introduced a transitional so that this requirement will only apply to new lending from January 2026 in response to concerns about the operational burden of checking existing agreements.

Separately, following industry feedback, the PRA has implemented the national discretion to allow recognition of credit derivatives without a restructuring as a credit event if certain criteria are met.

Obligor grade adjustments in IRB models

Supervisory Statement SS17/12 on CRM has been updated to clarify that firms’ IRB may reflect support arrangements by adjusting obligor grades in accordance with Art 172(1)(e). However, this approach is not available where the support arrangements are recognised by a firm using the LGD Adjustment Method in Art 171(3)(b).

Output Floor

The PRA has finalised the rules to implement the Output Floor (OF) broadly in line with the proposals, with technical fixes for accounting provisions and a shorter phase in period to recognise the delay to implementation. In-scope firms are required to calculate RWAs as the higher of: (i) total RWAs calculated using the approaches for which the firm has supervisory permission (including Internal Model (IM) approaches); or (ii) 72.5% of RWAs calculated using only the standardised approaches (SAs).

The key change from the proposals is to amend the approach to accounting provisions to reflect feedback from firms:

- Where the expected loss (EL) amount exceeds the total amount of accounting provisions (P) firms must deduct the difference from Common Equity Tier 1 (CET1) capital
- Where the total amount of accounting provisions exceed EL, firms may add the difference to Tier 1 capital (up to a cap)
- If specific provisions exceed EL for defaulted exposures, there is a CET1 deduction and a T2 capital add-on.
- For the SA calculation, firms may add general provisions to T2 capital up to a cap.

The PRA has finalised its rules in line with the consultation and applies the OF at the level of the UK consolidation group, or on an individual basis where the firm is not part of a group. While UK-based subsidiaries of overseas groups would not be subject to the OF, there are reporting requirements and an expectation that an output floor is applied by the home jurisdiction. To accommodate different international implementation timeframes, firms may apply to be treated as international subsidiaries if their consolidated home state regulator has yet to implement the floor. As proposed, the OF would also be applied at the level of the consolidated Ring-Fenced Body (RFB) sub-group, or at the individual level where there is no RFB sub-group. The PRA highlights that it may reconsider the scope of application in the future.

The PRA has not made any changes to address firms' feedback on the treatment of securitisation exposures and significant risk transfer (SRT) in the output floor but it intends to consult on this issue again in a future consultation.

Firms will be required to use the OF in order to calculate RWAs for own funds requirements and all relevant capital buffers (including systemic buffers and Pillar 2).

To reflect the delay to the implementation of the rules the PRA has amended the phase in period from five years to four years so that the floor is fully phased in from 1 January 2030.

Pillar 2

The PRA has previously announced an off-cycle review of firm-specific Pillar 2 requirements to address the consequential impacts of Basel 3.1 Pillar 1 changes on Pillar 2. Firms are not expected to conduct a full Internal Capital Adequacy Assessment Process (ICAAP) for this off-cycle review but they will have to respond to the PRA's data collection exercise by 31 March 2025 .

The PRA believes that there is no material double count of risks between the output floor and the PRA's Pillar 2 methodologies. However, the PRA recognises that the introduction and phase-in of the output floor may have operational impacts on the calculation of Pillar 2 therefore the PRA will (i) rebase firms' Day 1 Pillar 2 (both variable parts of Pillar 2A and the PRA buffer) as part of the off-cycle review; and (ii) rebase firms' variable Pillar 2A requirements during the output floor transitional period, so that any changes to RWAs resulting from the output floor multiplier do not impact Pillar 2A capital requirements where the relevant risk level has not changed.

The PRA also plans to apply firm-specific structural adjustments to Pillar 2A (the 'SME lending adjustment' and 'infrastructure lending adjustment') to mitigate the increase in overall capital requirements for SME and infrastructure lending as a result of the removal of the Pillar 1 support factors in this off-cycle review. The benefit of the Pillar 2A adjustments will vary by firm depending on the amount of other applicable Pillar 2A add-ons.

The PRA plans to communicate the adjusted Pillar 2 requirements to firms before 1 January 2026, so that firm-specific requirements will be updated at the same time as the Basel 3.1 standards are implemented. The PRA will provide firms with more guidance as part of the next concurrent stress testing exercise to account for interactions between the output floor, stress testing and the PRA buffer.

Alongside the publication of the final Basel 3.1 rules, the PRA has published consultation paper CP9/24 to retire the refined methodology and streamline firm-specific capital communications.

The PRA also intends to consult on updates to the Pillar 2A methodologies in the future now that the PRA's rules to implement the Basel 3.1 standards are finalised. This is likely to cover the Pillar 2 treatment of Sovereign exposures, credit concentration risk, updates to the IRB benchmarks, interest rate risk in the banking book (IRRBB) and pension risk.

Disclosure (Pillar 3)

The PRA has published the final disclosure requirements for credit risk, market risk, credit valuation adjustment (CVA) risk, counterparty credit risk (CCR), operational risk and the output floor. The market risk, counterparty risk, CVA, output floor, capital summary disclosure templates and instructions have not been changed from the proposals. The credit risk templates and instructions have been updated to reflect the modifications in the final rules. The PRA has also made minor modifications to the operational risk disclosures.

Supervisory Reporting

The PRA has published the final supervisory reporting templates and instructions which will go live in 2026. There are a series of minor modifications and updates to the templates and instructions which firms will need to assess. Several of the credit risk updates have been made to reflect the policy changes in the final rules.

Firms in scope of the Basel 3.1 standards will no longer submit supervisory reporting requirements to the PRA using the European Banking Authority (EBA) taxonomy (effective from the implementation date). A draft of the Bank of England Banking taxonomy v3.7.0 was released in May 2023 and a final version is planned to be released following publication of the policy statement. Firms should continue to use the EBA Taxonomy 3.0 for Own Funds reporting and the Bank of England Banking taxonomy for Capital+ reporting up until the implementation date.

In due course, as part of the Banking Data Review (BDR), the PRA plans to review the full range of bank reporting data it collects with a view to making improvements and efficiencies.

Other relevant changes

While the final rules bring clarity to most areas of the post-crisis regulatory framework there are still areas that are yet to be finalised. We have sign-posted a number of those areas in this publication. In addition, the PRA will need to publish final rules on the Capitalisation of foreign exchange positions for market risk (CP17/23), large exposures, securitisation and the SFT haircut floors.

Update on US implementation of "Basel 3 End Game"

On September 10, 2024, Federal Reserve Board Vice Chair for Supervision Michael S. Barr provided significant updates on the Basel III endgame and Global Systemically Important Bank (G-SIB) capital surcharge.

The US Agencies will re-propose rules for the implementation of the Basel standards due to significant industry and political pushback on the first notice of proposed rulemaking, which significantly increased capital requirements for the US banks after the Spring 2023 banking failures.

The re-proposal will cover all major areas of the Basel standards and are expected to increase capital requirements by 9% for G-SIBs, 3-4% for large non-GSIB banks, and 0.5% for other banks. The full proposal is expected to be published by the end of September 2024.

Credit Risk

Residential Real Estate and Retail Exposures

Recommendations include lowering the risk weights for residential real estate exposures to align with Basel standards. This adjustment will result in reduced average capital requirements for mortgages with up to a 90% loan-to-value (LTV) ratio and maintain similar requirements for mortgages with up to 100% LTV.

Specific reductions will be proposed for low-usage credit card lines and charge cards with no pre-set credit limits.

Unrated Investment Grade Corporate Exposures

The re-proposal will extend the application of the 65% risk weight for unrated investment grade corporate exposures to include certain regulated, investment-grade entities that are not publicly listed. Previously, only publicly listed investment-grade corporates were eligible for the 65% risk weight.

Securities Financing Transactions

The proposed capital increase for securities financing transactions which do not meet the minimum haircut floors will not be included, which is consistent with the EU and UK.

Equity Exposures

The proposed revisions will allow a risk weight of 100% for tax credit equity financing exposures, aligning with the treatment of other tax credit investments such as low-income housing tax credits.

Operational Risk

In line with other major jurisdictions the re-proposals will remove the internal loss multiplier from the operational risk capital requirement, which means that a firm's operational loss history will no longer be captured in Pillar 1.

The re-proposal will require calculation of fee income on a net basis rather than the originally proposed gross basis.

It will be proposed to lower the operational risk capital requirements for investment management activities, reflecting the historically smaller operational losses for these activities relative to income.

Trading book activities

Internal Models for Market Risk

Due to the very limited number of banks which will use the Internal Model Approach for market risk, a multi-year implementation period for the profit and loss attribution test (PLAT) will be introduced to allow banks to improve systems, data, processes and address model performance.

Single Obligor for Mortgage-Backed Securities

The re-proposal will clarify that uniform mortgage-backed securities positions will be treated as having a single obligor, regardless of issuer being Freddie Mac or Fannie Mae.

Client-Cleared Derivatives

Reduced capital requirements will be proposed for the client-facing leg of a client-cleared derivative to better reflect the reduced risk due to collateral, netting and daily margining.

Scope of the rules ("Tiering")

G-SIBs and other internationally active banks

Under the re-proposal, G-SIBs and other internationally active banks will be subject to the full requirements, including the credit risk and operational risk requirements and the revised market risk and Credit Valuation Adjustment (CVA) frameworks.

Non-G-SIBs with $250-$700 Billion in Assets

The re-proposed rules will:

- Apply new credit risk and operational risk requirements
- Apply market risk and CVA frameworks only to firms with 'significant trading activity'
- Revert to the simpler definition of capital currently in place, with the exception of applying the requirement to reflect unrealized losses and gains on certain securities
- Firms would be required to include accumulated other comprehensive income (AOCI) in their capital calculations to better reflect interest rate risk in minimum capital requirements.

Large Banks with $100-$250 Billion in Assets

The re-proposed rules will:

- Not apply the expanded risk-based credit risk and operational risk frameworks.
- Maintain a simpler capital framework for these less complex firms
- Revert to the simpler definition of capital currently in place, with the exception of applying the requirement to reflect unrealized losses and gains on certain securities and other aspects of AOCI

G-SIB capital surcharge

The re-proposal will require banks to report indicators as average values instead of point-in-time values at reporting periods to limit 'window dressing' activity. Also, the G-SIB capital surcharge would be calculated in 0.1% increments instead of 0.5% increments to reduce cliff effects.

Inflation and economic growth will now be accounted for when measuring a G-SIB's systemic risk profile, ensuring surcharges do not change solely based on economic growth.

What does this mean for firms?

Significant implementation challenges	• Firms need to address **data challenges** and finalise a range of **judgements and interpretations** in short order • Challenge of managing a **fragmented approach across jurisdictions,** including divergent implementation timelines • Balancing implementation alongside **competing regulatory priorities** • **Technology enablement is critical** especially given broader constraints
Competitive landscape	• A shake-up in the competitive landscape given **greater risk sensitivity** and a number of counterbalancing proposals • Concerns over whether the **gap between the large and mid-tier firms has widened** given a number of key changes (parental support, unrated corporates) are favourable to large UK banks • A number of **opportunities for consolidation** in the market
Evolving binding constraints and capital management challenges	• Clear **"winners" and "losers" have emerged** at a product level • Implications of changes under **Pillar 2 still unclear** • Other binding constraints such as **output floor and leverage ratio** will result in a **complex capital allocation challenge** • Broader implications on **pricing and cost of capital** will evolve over time • **Output floor attribution** across jurisdictions and entities will be critical
Internal model strategy	• **Cost-benefit analysis for internal models** essential especially in light of broader model risk requirements • More relaxed **roll-out requirements and "material compliance"** requirement could still **incentivise IRB approaches** • Consideration of **wider risk management benefits** and **Pillar 2 adjustment** will be a key determinant of modelling strategy
Assurance over RWAs	• Firms should **assess the impact on their current governance, processes, systems and controls** across all risk types • Firms should **achieve a high standard of compliance** for the first reporting period given the **prevalence of the s166 supervisory tool** and the widespread impact of the Basel 3.1 changes • **Assurance over the output floor** could result in significant challenges
Regulatory reporting	• Firms should r**eview the new and revised reporting templates** published by the PRA to ensure that they can submit complete and accurate reports by the first reporting deadline • Wider data review underway by UK regulators on how the Bank collects data (transforming data collection) and what data items and frequency is needed in the Banking Data Review

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