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PRA waters down key Basel 3.1 rules and reduces capital impact on banks

On 12 September 2024, the Prudential Regulation Authority (the "**PRA**") published the second set of near-final rules for the implementation of Basel 3.1 in PS9/24 (see here) following the publication of PS17/23 (see here) on 12 December 2023. Basel 3.1 refers to the standards of the Basel Committee on Banking Supervision (the "**BCBS**") entitled "Basel III: Finalising post-crisis reforms" and published in 2017 (see here) and the BCBS standards on the fundamental review of the trading book (the "**FRTB**") which were finalised in 2019 (see here).

PS9/24 is published against a backdrop of increasing uncertainty around the implementation of Basel 3.1 around the globe. In the EU, CRR3 implements the bulk of Basel 3.1 with effect from January 2025, although the effective date of the FRTB has been delayed until 1 January 2026, whilst the output floor is subject to material reliefs granted to firms on top of the transitional phase-in proposed by the BCBS. In the US, an initial set of proposals that included largely abolishing modelling permissions for credit risk received such significant pushback from the banking industry that regulators have agreed to revise heavily their proposals with a second round of consultations to begin shortly.

PS17/23 and PS9/24

Where PS17/23 covered, among others, the implementation of the FRTB and new rules on credit valuation adjustment risk and operational risk, PS9/24 addresses credit risk (comprising both the standardised approach ("**SA**") and the internal ratings based ("**IRB**") approach), credit risk mitigation, the output floor and Pillar 2 as well as disclosure (Pillar 3) and reporting requirements.

PS9/24 delays the effective date of Basel 3.1 to 1 January 2026 and involves a number of changes that substantially water down the PRA's original proposals set out in CP16/22, especially across the credit risk and credit risk mitigation frameworks. The regulatory capital impact of these changes is considerable. The PRA estimates that the Tier 1 capital requirements for major UK banks in aggregate are likely to increase by less than 1% by 1 January 2030, which is materially lower than the estimated 3.2% increase under the PRA's initial proposals. There is little doubt that banks will, for the most part, welcome these significant changes. In relation to other changes, the PRA has sought to clarify its position (e.g., the treatment of funded and unfunded credit protection) or decided to maintain its original proposals (e.g., the application of the output floor to the full capital stack of minimum requirements and buffers). A number of areas require further clarification for which the PRA intends to carry out separate reviews and consultations, including the interaction between the output floor and Pillar 2, the interaction of securitisation transactions and the output floor and certain new permissions concerning the output floor.

The FSMA 2000 model

On 12 September 2024, HM Treasury ("**HMT**") also published its proposed approach to applying the FSMA 2000 model to regulation to the Capital Requirements Regulation ("**CRR**") (see here). This will involve revoking those Articles of CRR in relation to which the PRA has proposed making rules for implementing Basel 3.1 as set out in PS17/23 and PS9/24 before eventually revoking those Articles that remain in CRR as it appears in UK statute books after the PRA's implementation of Basel 3.1. A draft statutory instrument for the first phase of revocations has been published (see here). In a third phase, the CRR equivalence regime will be restated in legislation alongside other aspects of CRR that are relevant to other areas of financial regulation, such as CRR definitions used in regulation for banks, building societies and investment firms.

This note

Following the publication of our note on the PRA's initial proposals on Basel 3.1 published on 30 November 2022 in CP16/22 (see the note here), we summarise in this note the key changes published in PS9/24 to the PRA's original proposals in CP16/22. We limit our analysis to:

- Chapter 2: Credit risk – standardised approach;
- Chapter 3: Credit risk – internal ratings based approach;
- Chapter 4: Credit risk mitigation;
- Chapter 5: Output floor; and
- Chapter 6: Pillar 2.

Other Basel 3.1 changes

With Basel 3.1, firms will also be required to implement (among others) the FRTB, which represents a fundamental overhaul of the regime for own funds requirements for market risk, a new regime for own funds requirements for credit valuation adjustment risks and a new regime for operational risk.

Chapter 2: Credit Risk – Standardised approach

In CP16/22, the PRA proposed a substantial overhaul of the SA to credit risk in accordance with the underlying Basel 3.1 rules. The purpose of the amendments to the SA was to increase risk sensitivity, to reduce mechanistic reliance on external ratings and to promote comparability between firms by reducing the variability of risk weighted assets ("**RWAs**"). While the PRA agreed to diverge in a few respects from the Basel 3.1 rules, in many other areas it adhered faithfully to the underlying rules, despite a different approach taken by the EU in certain cases, for example with the introduction of a number of EU specific transitional periods to stagger implementation and to reduce the cliff edge effect of higher capital requirements for certain exposure types.

The PRA received a large number of responses to its proposals, focussing in particular on the negative capital impact for UK banks of (i) the proposed treatment of SME lending and removal of the SME support factor; (ii) the removal of the infrastructure support factor; (iii) the proposed treatment of unrated corporate exposures; (iv) the proposed treatment of real estate exposures in particular the valuation at origination requirement; and (v) changes to credit conversion factors ("**CCFs**") for certain off balance sheet ("**OBS**") items. The PRA appears to have taken a number of these concerns on board and states that it has *"decided to make significant amendments to the draft rules and supervisory statements"*. We set out below a summary of the key revisions proposed by the PRA, as well as those proposals where the PRA has decided to retain its original approach (as set out in CP16/22).

Off balance sheet items and CCFs

The PRA proposed a number of changes to the treatment of OBS items, including a new definition of "commitment" and a change to CCFs for some OBS items and commitments. Despite a number of respondents asking the PRA to exercise its discretion to exempt certain arrangements with corporates/SMEs from the definition of "commitment", as is the case in the EU's CRR3, the PRA has decided to retain its policy and not exercise this discretion or change the definition of "commitment". In addition, the PRA has clarified that, unlike the EU, it will not introduce transitional arrangements to phase in the increase to 10% (from 0%) for unconditionally cancellable commitments, nor will it provide any additional clarity on the treatment of syndicated commitments.

However, the PRA has reduced its "super-equivalent" 50% CCF for other commitments to 40%, other than in relation to UK residential mortgage commitments. In addition, the PRA has decided that the proposed 50% CCF for "other transaction related contingent items" such as trade letters of credit and guarantees is not warranted and those trade finance items should be allocated a 20% CCF.

Unrated corporate exposures

The PRA in CP16/22 proposed a more risk sensitive approach than the 100% risk weight ("**RW**") under Basel 3.1 and CRR3 for unrated exposures, by allowing firms to allocate their investment grade ("**IG**") exposures at 65% RW, and non-IG exposures at 135%, provided they receive permission from the PRA. Firms could not pick and choose – they either had to apply the risk sensitive treatment to all their unrated corporate exposures, or the 100% RW. A number of respondents argued that the proposed risk weights were calibrated too conservatively (in particular for non-IG exposures) and that the 135% RW for non-IG exposures would have a negative impact on the competitiveness of the UK.

In response, the PRA expressed that it had not received sufficient evidence to reduce the risk weightings and that the risk weights as set broadly align with the overall calibration of Basel 3.1 standards. The PRA has, therefore, not changed its proposed treatment of unrated corporate exposures.

Specialised lending exposures and infrastructure support factor

In accordance with Basel 3.1 standards, the PRA proposed introducing a new specialised lending ("**SL**") exposure class (within the corporate exposure class) similar to the existing SL rules under the IRB approach, with allocated risk weights for commodities finance, object finance and project finance. One of the key proposals was the removal of the infrastructure support factor which applies to project finance and other corporate exposures that meet certain conditions. The PRA argued that the lower RW of 80% for unrated "high quality" project finance exposures in the "operational phase" compared to the 100% RW for non-high quality project finance exposures or the 130% RW for project finance exposures in the pre-operational phase would lead to a similar risk weight adjustment as the infrastructure support factor.

A number of respondents were critical of this approach, arguing that removing the support factor would negatively impact the international competitiveness of the UK and would decrease such lending volumes in the future, in particular for the financing of green infrastructure projects. In addition, it was noted that the RW of 80% would not offset the support factor, as most lending was done in the pre-operational (rather than the operational) phase.

The PRA has taken these arguments into account and has made material revisions to its policy. While it has retained the 80% RW for high quality project finance, it has widened the scope of eligible counterparties that the borrower depends on for revenue to include central banks and certain international organisations. In addition, while it has maintained the proposed removal of the infrastructure support factor in the Pillar 1 rules, it has provided for a firm specific "infrastructure lending adjustment" to reduce Pillar 2A capital requirements to offset any increase in overall capital requirements from the removal of the infrastructure support factor.

Exposures to SMEs and the SME support factor

The PRA proposed (i) changing the risk weight for exposures to SMEs (in accordance with the underlying Basel 3.1 standards) by introducing a new corporate SME exposure sub-class with RW of 85% and a new "transactor" sub-class with RW of 45% as well as retaining the existing 75% RW for retail SME exposures; (ii) removing the SME support factor (a CRR specific provision); and (iii) maintaining the existing requirement that exposures to SMEs secured by commercial real estate receive RW that is no lower than 100%.

The PRA had argued in CP16/22 that the removal of the SME support factor was warranted, as the SME support factor would result in an "unwarranted" doubling up of lower risk weights for SME exposures, given the reductions in SME risk weights in the Basel 3.1 standards from 100% to 85%. A large number of respondents disagreed with the PRA's rationale, arguing that the removal of the support factor would reduce lending to SMEs and increase the cost to SMEs of bank lending as the increased capital cost would be passed onto borrowers, with the lower risk weights not compensating for the loss of the support factor. In addition, it was claimed that this would disproportionately affect smaller banks, an important source of finance to SMEs.

In response, the PRA has made significant changes to its SME policy. Similar to its approach to the infrastructure support factor, it has decided to maintain the policy of removing the SME support factor in compliance with the BCBS standards and instead apply a Pillar 2A adjustment known as the "SME lending adjustment" to ensure that the removal of the factor does not increase capital requirements for SME exposures. The PRA has also removed the 100% RW floor for exposures to SMEs secured by commercial real estate where (i) the exposure meets the regulatory real estate definition and (ii) repayment is not materially dependent on cashflows from the property. In addition, there will be a new simplified and expanded definition of SME which requires firms to assess the turnover on the basis of the approach to accounting consolidation. The PRA has retained all other aspects of its proposed SME rules, including the 85% RW for corporate SME exposures.

Real estate exposures

In CP16/22, the PRA proposed a number of changes to the risk weighting of real estate exposures, including a more granular and risk sensitive treatment of "regulatory" real estate exposures which are not materially dependent on cash flows generated by the property, and a new valuation requirement. The PRA proposed that the value for both residential and commercial property should be the value at origination, namely the valuation obtained by the bank when it issued a new mortgage for the purchase of the property or when a bank refinanced an existing or new loan. A firm could use an updated valuation only when (i) an event occurs which results in a permanent reduction in the value of the property, (ii) there is a significant decrease in the market value of the property or (iii) modifications are made that increase the value of the property. Respondents argued that limiting banks to value at origination was not risk sensitive, as it would not reflect the current market value, be unsuitable for products with longer term fixed periods and create inconsistency between firms using the SA and the IRB approach.

In response, the PRA has made a number of changes to its draft real estate exposures policy, including the following:

- Firstly, the PRA has amended the definition of "residential real estate" to remove specific exclusions (e.g., purpose-built student accommodation) and instead introduced an expectation that firms should treat property as residential only where it could be used as a standard residential dwelling with holiday lets, care homes or purpose-built student accommodation being unlikely to meet the definition.
- Secondly, while the PRA has kept the "finished" requirement for regulatory real estate, it has exempted self-build loans from the finished property requirement.
- Thirdly, the PRA has amended the rules on valuation of real estate collateral. While it has maintained the requirement that the value of the property should be its value at origination, it has introduced a revaluation "backstop", requiring firms to obtain an updated valuation every five years, which is reduced to three years if the loan is more than a certain amount. In addition, the PRA has amended its rules to clarify that firms must only obtain an updated valuation in relation to a broader decrease in market prices if the value of the property has fallen more than 10% from the most recent valuation. The PRA has also removed the prudent valuation criteria.
- Finally, the PRA has amended the draft rules for "regulatory commercial real estate" to remove the 100% risk weight floor for exposures to SMEs and other corporates that are not materially dependent upon cashflows generated by the property.

The PRA has, however, decided to retain a large number of its real estate exposure proposals, including (i) for regulatory residential real estate that is not materially dependent on property cashflows, the 20% RW for up to 55% of the value of the property and RW of the borrower to the remainder; (ii) the adjusted loan splitting approach for second charge holders; and (iii) the exemption for an exposure to an individual who has no more than three mortgaged residential properties in total from being classified as materially dependent on property cashflows.

Equities and subordinated debt

The PRA has decided to retain its proposal to apply a 400% RW to venture capital type exposures and a 250% RW for all other equity exposures. However, having taken into account respondents' concerns, the PRA has made significant amendments to the criteria for assigning a 400% RW. Instead of referring to "venture capital", the 400% RW applies to exposures to businesses that are less than five years old.

Chapter 3: Credit Risk – Internal ratings based approach

In CP16/22, the PRA introduced draft rules to amend a number of the provisions relating to the IRB approach to credit risk, based, for the most part, on the underlying BCBS standards. These changes were designed to address the excessive variability across firms in the calculation of RWAs for credit risk and attempt to restore the credibility of the IRB framework itself. The proposed revisions included (i) completely removing the use of the IRB approach for exposures to central governments, central banks and equities; (ii) removing the use of the Advanced IRB ("**A-IRB**") approach for exposures to institutions (and quasi-sovereigns), large corporates and financial corporates; (ii) adopting input floors; and (iii) providing greater clarity on how to estimate the various inputs such as loss given default or probability of default to create more consistency in approaches. The responses to these changes were in general more supportive than the proposals for the standardised approach to credit risk and focussed more on requesting the PRA to clarify its position or provide further guidance than make wholesale changes to the proposals. Set out below are a few key revisions and clarifications made by the PRA:

- clarification that it will not require IRB models to be fully compliant on 1 January 2026, provided that firms have a remediation plan in place and a date for implementation of their new model or model changes;
- revision to the treatment of quasi-sovereigns which can no longer be modelled under the Foundation IRB ("**F-IRB**") approach;
- removal of undrawn commitments from the SME retail class;
- inclusion of the Pillar 2A SME lending adjustment and the Pillar 2A infrastructure lending adjustment to account for the removal of the SME and infrastructure support factors;
- removal of the unrecognised exposure adjustment for firms that use the A-IRB or F-IRB approach;
- clarification that the 1.25% correlation multiplier should not apply to the treasury entities of non-financial corporate groups and that the A-IRB approach can be applied to such exposures;
- retention of the 0.1% PD input floor for UK retail residential mortgage exposures, despite respondents' concerns that it was too conservative and double the 0.05% floor in Basel 3.1;
- revision to rules on adjustments to obligor grade assignments so that undocumented, as opposed to only written, support arrangements (e.g., parental support) can be taken into account;
- clarification that firms cannot model exposure at default ("**EAD**") for any on-balance sheet exposures which are unconnected to a revolving facility;
- notification that HMT will remove the concept of unadvised limits from the CRR definition of "conversion factor" ("**CF**"). However, where EAD or CF is modelled under the A-IRB approach, the PRA clarifies that it expects firms' models to capture the "balance at default" whether this is from advised or unadvised limits; and
- revision to the definition of "high-volatility real estate" to clarify that it only includes commercial real estate and real estate under development where the ultimate use will be commercial.

Chapter 4: Credit risk mitigation

In relation to credit risk mitigation ("**CRM**"), the PRA's CP16/22 introduced a number of proposals ranging from restructuring the categorisation of different CRM techniques to clarifying the treatment of such techniques. In PS9/24, the PRA sets out a number of changes to the proposals in CP16/22 of which the following changes stand out from among changes to eligibility and calculations.

UFCP covered by FCP

The PRA introduces a new decision tree for funded credit protection ("**FCP**") securing unfunded credit protection ("**UFCP**") covering an exposure. An obvious example would be a collateralised guarantee which the PRA had previously, in occasional consultation paper CP2/17 in February 2017 (see here), considered should be treated as UFCP but chose not to incorporate that view into its supervisory expectations on CRM. In PS9/24, the PRA sets out a new decision tree on collateralised guarantees and other forms of UFCP secured by FCP which finally confirms that:

- in line with a position commonly adopted by the industry, if the UFCP is not eligible CRM because the protection provider is not in the list of eligible providers, then the UFCP is not eligible, but the FCP is eligible up to the value of the UFCP, provided the requirements for FCP are fulfilled;
- if both the UFCP and the FCP are eligible, a firm can choose (i) to apply both the UFCP and the FCP; (ii) to disregard the UFCP and apply the FCP; or (iii) to apply the UFCP and disregard the FCP, although under limbs (i) and (ii), the benefit of the FCP is limited to the value of the UFCP; and
- if the UFCP is not eligible CRM for reasons other than the eligibility of the protection provider, neither the UFCP nor the FCP can be recognised.

FCP

Firms can now apply the financial collateral comprehensive method to exposures subject to the slotting approach, such as specialised lending exposures.

Transactions on the trading book that are subject to counterparty credit risk:

- For repurchase transactions and securities or commodities lending or borrowing transactions, the PRA waters down its CP16/22 proposal of limiting collateral eligibility to collateral actually held on the trading book. As is currently the case, collateral will be eligible if it qualifies for inclusion in the trading book, but firms will now additionally be expected broadly to demonstrate that they (i) can exit the position; (ii) have the legal and operational capabilities to trade the financial instrument; and (iii) can value the position within the trading book and manage risks.
- For margin lending transactions that involve title transfer, the PRA confirms its view that these can be treated as securities or commodities borrowing or lending transactions and, therefore, benefit from the wider collateral eligibility for such transactions on the trading book.

Material positive correlation between the value of the collateral and credit quality of the obligor:

> Existing limitations on own-issued securities are maintained, as the PRA continues to be of the view that the risk of material positive correlation is mitigated for only a limited number of own-issued securities (e.g., certain covered bonds posted as collateral in specific transactions).

> Interestingly, the PRA acknowledges that for certain collateralised transactions whose exposure value is a function of collateral value, there is no risk of material positive correlation, provided that a fall in collateral value does not result in a fall in the ratio of collateral value to exposure value before taking into account the effects of the collateral (e.g., sold covered call options).

UFCP

In CP16/22, the PRA proposed introducing a new requirement that UFCP must not contain a clause allowing the protection provider unilaterally to change the protection to the detriment of the lender. The PRA has considered the feedback received but does not intend to change its approach. This expands the existing requirement against rights for a protection provider unilaterally to cancel the protection and may cause eligibility challenges for some forms of UFCP.

In relation to credit insurance, the PRA considered feedback received in relation to the loss-given default factor to be applied to the covered portion for firms using the parameter substitution method and maintains its original proposal of applying a factor of 45% despite a claim on the insurance policy ranking in the creditor hierarchy above a direct exposure to an insurer. The PRA is of the view that any changes to this factor would need to be agreed upon internationally before the PRA will consider changing its position.

A number of technical changes are introduced, including that:

> counter-guarantees will be limited to those provided by central banks or central governments; and

> credit default swaps will be recognised as eligible CRM even if restructuring resulting in a credit loss is not included as a credit event, provided that certain requirements are fulfilled, including that any amendments to the maturity, principal, coupon, currency or seniority of the protected exposure require a 100% vote in favour.

Chapter 5: Output floor

The output floor is one of the most significant changes being introduced through Basel 3.1. In short, over the course of a transitional period, firms will be required to floor their RWAs calculated using models at 72.5% of RWAs calculated using the standardised approach (the latter being referred to as floored RWAs).

In PS9/24, the PRA provides an update on transitional arrangements and responds to industry feedback to the CP16/22 proposals:

> Despite the delay to the effective date of Basel 3.1 to 1 January 2026, the PRA intends to reduce the transitional period of the output floor from 5 to 4 years to maintain the transitional period end date of 31 December 2029. To that end, the transition will start with a multiplier of 55% on 1 January 2026 rather than a multiplier of 50% as proposed in CP16/22 for a start date on 1 January 2025.

> Accounting provisions and their impact on RWAs under modelled approaches will be incorporated into the output floor calculation by converting the effect of the difference between expected loss and accounting provisions on capital resources into equivalent RWAs.

> A new permissions regime is introduced to allow UK subsidiaries of groups headquartered overseas whose parent entities are subject to the output floor on a consolidated basis in their home jurisdictions to apply to the PRA to be treated as an "international subsidiary" under the output floor regime and, therefore, be exempt from applying the output floor at the level of the UK subsidiary. Permission is granted if the PRA is satisfied that there is public commitment to implement the output floor in the home jurisdiction.

> The PRA confirms that mutuals and ring-fenced sub-groups will be subject to the output floor.

> The PRA maintains its original proposal of applying the output floor to the whole capital stack with the effect that, if RWAs calculated using modelled approaches exceed 72.5% of RWAs calculated using the standardised approaches (i.e., floored RWAs), then floored RWAs will apply to calculations of the capital conservation buffer, the countercyclical buffer, the G-SIB and O-SII buffers and the Pillar 2B buffer (otherwise known as the PRA buffer).

> The impact of the output floor on securitisation exposures and the origination of significant risk transfer securitisations continues to be under review following feedback received in response to DP3/23, as firms had raised a number of concerns, including a possible adverse impact on lending capacity.

Chapter 6: Pillar 2

In relation to Pillar 2, the PRA provides little additional clarification beyond acknowledging that some uncertainty remains regarding the interaction of the output floor with Pillar 2 and Pillar 2A in particular which the PRA intends to address in an off-cycle review of Pillar 2. That off-cycle review will also be used to address double-counting and unwarranted increases and decreases in capital from changes to Pillar 1 RWA calculations and requirements. To that end, the PRA intends to:

> rebase credit risk add-ons in Pillar 2; and

> consider, as discussed in relation to Chapter 2 on credit risk under the standardised approach, firm-specific structural adjustments to Pillar 2A to avoid increases in capital for SME and infrastructure lending given the removal of the support factors for such lending under Pillar 1.

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