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Basel 3.1 Implementation in the UK: An Update on PRA Reforms

On 12 December 2023, the UK Prudential Regulation Authority (PRA) published the first of two near-final policy statements on the implementation of revisions to the Basel 3 standards, known in the U.K. as Basel 3.1. This followed the regulator's consultation on the same topic in November 2022.

In this alert, we focus on the following reforms, which are set out in the near-final policy statement (PS):

- the interim capital regime for smaller banks;
- market risk standards;
- credit valuation adjustment (CVA) and the counterparty credit risk framework;
- operational risk standards; and
- the interaction with Pillar 2.

The remaining material from the 2022 consultation paper will be addressed in a second near-final PS, due in the second quarter of 2024, in addition to separate reviews of the Pillar 2 framework. We will release further updates on these developments and their significance as they progress.

In two significant departures from the consultation paper, the near-final PS:

- aligns the approach to sovereign exposures between the market and credit risk frameworks by prohibiting the use of internal modelling for sovereign default risk in the market risk framework; and
- adds an additional transitional mechanism firms can use to adjust to the removal of existing exemptions to certain CVA capital requirements.

The EU and US are also developing frameworks to implement the revisions to the Basel standards. The EU has set an implementation date of January 2025, while the UK and US are aiming for July 2025. The asynchronous timing raises concerns over an unlevel playing field whilst the revisions come into effect in the UK and US.

Expected increases in Tier 1 capital requirements also vary. The PRA estimates that Tier 1 capital requirements for large firms will increase by 3.2% at the end of the transitional period on 1 January 2030. By contrast, the European Banking Authority forecasts a 9.9% rise in Tier 1 capital requirements for EU banks, and US bank regulators expect an aggregate increase of 16% for relevant US bank holding companies.

Key features of the PRA's near-final PS are set out below.

Interim Capital Regime

For small and domestic deposit takers (SDDTs), the consultation paper's proposals relating to the capital regime to apply remain largely unchanged, albeit renamed from the Transitional Capital Regime to the Interim Capital Regime (ICR). Eligible firms will not be subject to Basel 3.1 requirements following its implementation, but will

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continue to apply requirements under the existing Capital Requirements Regulation (CRR) instead, which will continue in effect until the final risk-based capital framework for SDDTs is in force. For more on the SDDT regime, including its eligibility criteria, please see the 28 December 2023 issue of The Capital Ratio, "Roundup of Upcoming U.K. Regulatory Reforms for Financial Institutions."

Market Risk

The PRA clarified certain aspects of the application of the market risk framework. That proposed framework consists of three new approaches: the simplified standardised approach (SSA), the advanced standardised approach (ASA) and the internal modelled approach (IMA).

The consultation paper imposed new requirements on the allocation of positions to the trading and non-trading books and the resultant application of market and credit risk frameworks. While the near-final PS makes no changes to this, it clarifies that certain exchange-traded Collective Investment Undertakings (CIUs) are to be considered as listed equities when calculating market risk capital requirements. This may alleviate concern banks have expressed over the approach to CIUs under the Basel reforms, as firms can avail themselves of lower risk weightings available in respect of equity risk positions.

Advanced Standardised Approach

The near-final rules allow for a wider scope of eligible third parties that firms may use to help calculate ASA capital requirements for CIUs than originally proposed, subject to the review of an external auditor. The near-final PS also clarifies the need for separate risk weights for the different elements of the ASA when calculations are undertaken by third parties.

In addition, the PRA elaborates on the scope of positions or risks likely to fall within scope of the new Residual Risk Add-On (RRAO). The RRAO is one of three elements constituting the ASA capital requirements, and it is intended to account for the more exotic or complex risks found in some positions. Instruments with an exotic underlying, such as longevity, natural disaster or weather, would be subject to this add-on, as would instruments with certain embedded optionalities. In the near-final PS, the PRA clarifies that it is excluding exactly matching back-to-back transactions from the RRAO that might otherwise be within scope. This exemption, however, does not extend to constant maturity swap options.

Internal Modelled Approach

Changes made to the IMA include the 75% minimum coverage requirement for stress period risk factors being imposed at a portfolio level, and not for individual trading desks. Consequences for breach of this requirement are now imposed after one month rather than two weeks.

A key amendment from the consultation paper relates to the modelling of sovereign default risk. Within the credit risk framework, the PRA proposes the implementation of a credit risk standardised approach to the risk-weighting of sovereign exposures. This would allow for a 0% risk weighting to central bank or government exposures in certain circumstances. By contrast, the IMA default risk model (IMA-DRC) proposed under the market risk framework imposed a three basis-point floor probability of default for the same exposures. In the near-final PS, this inconsistency has been resolved by precluding the modelling of sovereign default risks under the IMA-DRC. For trading desks using the IMA that have sovereign exposures, the ASA is to be used, which is closely aligned to the standardised approach to credit risk. The IMA will continue to apply to the other relevant risk components.

Data Quality Standards for Non-Modellable Risk Factors

The near-final PS introduces changes to enhance the flexibility of calculating non-modellable risk factors (NMRFs), a component of the IMA. NMRFs have generated significant attention during the Fundamental Review of the Trading Book. They are risk factors, particularly relevant to illiquid securities where there is insufficient real price data, and which therefore warrant a capital surcharge.

As a result of the changes made by PRA, firms can now use one price observation to derive multiple risk factors where appropriate. This accommodates sophisticated instruments that may have numerous risk factors relating to one price point. The change may allow more risk factors to meet the requisite number of price observations, and thus qualify as modellable.

Further, the NMRF framework now allows a firm to use either regulatory or firm-defined "buckets" for the different dimensions of a single risk factor, though only one variety of bucket can be used per dimension. A bucket is a standard that is set to determine whether a particular observed transaction can be counted as an observation for a risk factor, making it more likely to qualify as modellable.

One further change made to the IMA is the permitting trading desks that manage IMA-ineligible positions to be included in a firm's IMA application, so long as any ineligible positions are addressed through the ASA.

Credit Valuation Adjustment and Counterparty Credit Risk

The CVA risk framework introduced three new methodologies for calculating capital requirements: the basic approach (BA-CVA), the standardised approach (SA-CVA) and the alternative approach (AA-CVA).

The near-final rules largely retain the draft rules, with the PRA confirming the removal of existing exemptions relating to transactions with sovereigns and non-financial counterparties (NFCs). The PRA also removed the exemption for transactions with pension funds. However, the PRA's approach, unchanged in the near-final PS, eases the capital requirements for these transactions by assigning pension funds a distinct risk category and weight.

There will be an alternative transitional route to account for legacy trades in the CVA calculation. Other changes include an amendment to the definition of pension scheme arrangements to include third-country arrangements and to the definition of intragroup transactions to account for transactions between certain overseas group entities.

The calibration of capital requirements for derivative exposures using the standardised approach to credit risk (SA-CCR) is unchanged in the near-final PS. In its consultation paper, the PRA proposed adjusting the calibration of these exposures where the relevant counterparties are pension funds or NFCs. This was due to the SA-CCR arriving at substantially greater exposure values than those derived from the modelled approaches under the Internal Models Method. To address this, the PRA proposed reducing the "alpha factor" applied to derivative exposures from 1.4 to 1 in the calculations of these exposures. The alpha factor is a multiplier applied to exposure estimates to capture risks otherwise unaddressed by the SA-CCR.

Operational Risk

Two notable changes from the draft rules have been introduced relating to operational risk. The first is the exclusion of divested activities from the business indicator (BI) calculation. The BI represents a firm's scale and economic activity. It is used in the calculation of operational risk capital requirements under the standardised approach for operational risk. The exclusion of divested activities is subject to supervision, and it applies where a firm has undertaken disposals of entities or activities during the three-year period used to calculate he BI.

The second change enables firms to use business estimates in lieu of audited figures when calculating the BI should audited figures prove unavailable.

The remaining parts of the operational risk framework remain largely as originally proposed, with the PRA confirming that the internal loss mechanism will be set to one to ensure historic losses do not exert an outsized influence on the assessment of future exposures.

Pillar 2

Though no proposals were made relating to Pillar 2, the near-final PS includes a high-level assessment of the implications of Pillar 1 changes on Pillar 2, reiterating that there would be no duplication of capital requirements between the two regimes. The PRA plans to publish a second near-final PS that addresses Pillar 2 credit risk methodology and a review of firm-specific Pillar 2 capital requirements before the final implementation of Basel 3.1.

The PRA confirmed that it plans to adjust the Pillar 2A operational risk requirements to account for any changes effected to Pillar 1 operational risk capital. Changes to the relevant Pillar 2 capital requirements, as well as rebased market risk, CVA risk-related or variable add-ons will be adjusted to ensure changes to Pillar 1 RWAs do not result in double counting or unwarranted requirements for an unchanged risk profile. Firms' PRA buffer will also be rebased to account for the possible impact of unrelated RWA changes.