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ECRS Perspective

Basel 3.1 near-final rules part 2: is it the final countdown?

Digging deeper into the PRA's near-final policy statement on Basel 3.1

Target audience: Board Risk Committees, CFOs, CROs, Basel Programme Leads, Heads of Credit, Heads of Reporting

Reading time: 10 minutes

At a glance: The PRA has published its last set of near-final rules[1] for Basel 3.1. The package is wide-ranging, covering credit risk, credit risk mitigation, the output floor, Pillar 2, Pillar 3, and reporting. The PRA has also published a consultation on the capital regime for Small Domestic Deposit Takers. The key points include:

- The implementation date for the whole Basel 3.1 package is delayed until 1 January 2026.
- In line with the PRA's CP16/22 proposals, infrastructure and SME supporting factors will be removed from Pillar 1, increasing RWAs in the core Pillar 1 measure. However, the PRA has undertaken to reverse the effect of removing the supporting factors in Pillar 2A. This change in

[1] The rules are badged as "near-final" because HMT needs to lay legislation to repeal parts of the existing legal instruments to allow the PRA to finalise the rules. To all intents and purposes these rules are final.

particular is evidence of the PRA taking seriously its secondary competitiveness objective, albeit the PRA will need to address a number of industry concerns as a result:
    - it gives control over the capital effect to the PRA;
    - it is not clear where the capacity exists in Pillar 2A to "give back" the capital;
    - leaving the increase in Pillar 1 means that, as the macro-prudential buffers are based on Pillar 1 RWAs, there could be a gearing effect to total capital;
    - it will put the onus on firms to provide data to demonstrate the value of the increase in capital in each category; and
    - it is not clear how the adjustment will work over time, as firms' exposures in the affected portfolios evolve.
- There is no change to the risk weights for exposures to unrated non-SME corporate obligors, which remain at 65% for investment-grade and 135% for non-investment-grade if firms choose to apply to use the risk-sensitive approach, or 100% for all non-SME obligors otherwise.
- Where the PRA has made changes to the proposal on which it consulted in 2022 these are predominantly due to industry providing compelling data to support proposed amendments, including:
    - reduced conversion factors for transaction-related facilities;
    - reduced conversion factors for "other facilities";
    - removing the 100% risk weight floor for SME lending secured by real estate (when the real estate is used by the SME for its business); and
    - lower risk weights for "super strong" obligors in IPRE and Project Finance categories.
- We have published a separate analysis of the key provisions of the Small Domestic Deposit Takers regime:
    - firms will have to implement the rules by 1 January 2027;
    - the credit rules are a slightly simplified version of the Basel 3.1 Standardised approach for Pillar 1 credit, the approach for operational risk is as per Basel 3.1, and a more substantially revised and simplified Pillar 2 approach is proposed; and
    - from 1 January 2026 to 1 January 2027, firms will be able to apply what are essentially the current CRR rules under an Interim Capital Regime.
- As always, there is devil in the detail: there are a number of detailed changes to the rules that will affect how, for example, real estate valuation processes operate in practice. Firms will need to undertake a comprehensive review of the regulatory interpretations that underpin their analysis of the impact of Basel 3.1 on their business strategy at the portfolio and product level. They will also need to review their programme plans to ensure that where details have changed in the underlying rules these are incorporated into the flow of data and exposures through the capital calculation process. The "Digging deeper" section below gives an example of a detail change and its implications.

For firms with a UK and EU footprint the immediate competitive advantages of each regime are now clear. Revised US Basel endgame proposals have not yet been published, but the direction of travel indicated by officials includes broad and material changes across credit risk, operational risk, and market risk and significantly lower the capital impacts versus the prior proposal. Implementation may be further delayed if US regulators want to allow a 12-month period for firms to implement once rules are finalised.

Firms adopting Basel 3.1 should expect the PRA to have little to no sympathy for a less than fully compliant implementation on 1 January 2026.

Introduction

On 12 September 2024 the PRA published the second part of its near-final rules on Basel 3.1. The first near-final rules (published in December 2023) focused on reforms to the trading book, counterparty credit risk, credit valuation adjustments and operational risk. The second near-final rules comprise a wide-ranging set of policy, supervisory and consultation documents setting out the final part of the rules on Basel 3.1, proposals for a regime for Small Domestic Deposit Takers, and consultations on capital, Pillar 2A and the framework for capital buffers as listed below:

- Policy Statement 9/24 - Implementation of the Basel 3.1 standards near-final part 2.
  - Supervisory Statement 3/24 - Credit risk definition of default.
  - Supervisory Statement 4/24 - Credit risk internal ratings based approach.
- Consultation Paper 7/24 - The Strong and Simple Framework: The simplified capital regime for Small Domestic Deposit Takers (SDDTs).
- Consultation Paper 8/24 - Definition of Capital: restatement of CRR requirements in PRA Rulebook.
- Consultation Paper 9/24 - Streamlining the Pillar 2A capital framework and the capital communications process.
- Consultation Paper 10/24 - Updates to the UK policy framework for capital buffers.

The top-down view

The PRA has further delayed the implementation date for Basel 3.1 in the UK until 1 January 2026. Given this is the latest in a long line of delays to the implementation date, the PRA will expect firms' compliance with the new rules to be comprehensive and complete. Supervisory tolerance for firms that are not fully ready for day one will likely be zero.

The PRA estimates that the overall impact of the Basel 3.1 package will reduce from an increase in capital for major UK firms of 3.2% for the CP16/22 version to an increase of less than 1% by 1 January 2030. The basis for this reduced estimate is not detailed in the Policy Statement.

Unsurprisingly, much of the immediate reaction to the package has focused on the reduction in capital increases where the PRA has stepped back from its position in the original consultation. Where the PRA has made changes in response to industry feedback, it has generally been where the industry has provided the PRA with compelling data that supports the change requested.

However, focusing on the headline reduction in the proposed capital increase risks obscuring some important detail:

- the PRA has not moved at all on one area of significant industry pushback – the risk weights for exposures to unrated corporates;
- the changes the PRA has made to maintain the overall effect of SME and infrastructure supporting factors gives it control over the extent to which capital is offset against those portfolios, and this will in turn depend on the quality of the data a firm provides to support its case that the supporting factor is justified;
- in some areas, particularly real estate, the PRA has made changes that significantly affect how exposures are classified and treated; and
- overall, many of the rules are unchanged from the proposals in CP16/22.

Concessions, simplifications and clarifications have been made, but the value of the benefits – either financial or operational – will depend on an individual firm's business model and portfolio attributes.

The bulk of the PRA's rules and guidance will appear familiar and closely aligned with BCBS standards, but numerous subtle rule changes could result in fairly significant (and unexpected) changes to how exposures are treated, particularly in the real estate exposure class.

The table below sets out some of the key areas of industry feedback on the proposal, and how the PRA approach has changed – or not – in the final rules. It also sets out the comparable position in the EU CRD6/CRR3 package. Annex One to this document sets out our view of the key points for firms from PS9/24 on a section-by-section basis.

Key Issues from CP16/22

Policy issue	Industry viewpoint	Final proposal	Direction of change	Comparison with EU
Withdrawal of SME and infrastructure supporting factors.	Withdrawing the supporting factors will increase cost and have competitiveness implications for SME and infrastructure financing. Some lenders have started reducing SME lending in anticipation of final rules.	The supporting factors will be withdrawn but the PRA intends to make firm-specific "structural adjustments" to Pillar 2A to ensure overall capital requirements are not increased for SME and infrastructure lending. The PRA has amended the definition of SME with the aim of reducing the operational burden and broadening the scope of exposures that qualify for SME concessions. The 100% risk weight floor will not apply to SME borrowers for "own premises" CRE exposures. For IRB firms, a new lower 50% risk weight will apply to "substantially stronger" project finance exposures under the slotting approach.	In principle, the combination of "structural adjustments" and new concessions have the potential to mitigate overall increases in capital for SME and infrastructure lending. • However, the PRA will need to address a number of industry concerns as a result: ○ the proposals mean control over the capital effect rests with the PRA; ○ it is not clear that all firms have the capacity in Pillar 2A to allow the PRA to reverse the capital cost; ○ leaving the increase in Pillar 1 means that, as the macro-prudential buffers are based on Pillar 1 RWAs, there could be a gearing effect to total capital; ○ it will put the onus on firms to provide data to demonstrate the value of the increase in capital in each category; and ○ it is not clear how the adjustment will work over time, as firms' exposures in the affected portfolios evolve.	CRR3 retains existing SME and infrastructure supporting factors (EU-specific deviations from BCBS standards). However, CRR3 did not adopt the new 85% concessionary risk weight for non-retail qualifying SME and restricts the application of the infrastructure supporting factor to "high quality" project finance. Similar overall capital requirements <u>might</u> be achievable, but EU rules provide more certainty and less complexity.

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Exposures to non-SME unrated corporates.	Risk weighting non-investment grade exposures at 135% encourages counterparty migration to non-UK lenders. Financing costs for UK corporates are likely to increase.	The PRA has not revised the calibration of its optional risk-sensitive approach for non-SME unrated corporates. To recap: firms must choose <u>either</u> to apply a 100% risk weight to all unrated corporate exposures, regardless of riskiness; or to apply a 65% risk weight to investment grade exposures, but then to apply a 135% risk weight to non-investment grade exposures. Moreover, the PRA has indicated that it will consider setting guidance around the definition of "investment grade" if it observes inconsistent application of the rules.	The final calibration is likely to be a disappointment to industry. It is difficult to envisage an outcome other than lenders targeting investment grade borrowers that take advantage of the 65% risk weight and those lending predominately to non-investment grade borrowers adopting the flat 100% risk weight option.	CRR3 includes a transitional allowance, until 31 December 2032, to assign a 65% risk weight to unrated corporates where the PD of obligor does not exceed 0.5%. Relief is available to IRB firms only. All other non-SME unrated corporates are risk weighted at 100% for the calculation of the output floor (and SA generally).
"Basel plus" calibration of credit conversion factor for *other commitments* (50% PRA vs. 40% BCBS).	Increasing capital requirements for committed facilities places UK lenders at a competitive disadvantage and will adversely affect the UK economy. Higher conversion rates for residential mortgage commitments should be addressed through targeted rules.	Except for UK residential mortgages, the conversion factor for "other commitments" has been lowered to 40% (in line with BCBS). A 50% conversion factor will apply to UK residential mortgages.	The PRA's final rules are closer to BCBS standards, but the conversion factor for UK residential mortgages will increase significantly (30pp) compared with current rules.	CRR3 applies the BCBS 40% conversion factor for off-balance sheet items assigned to "other commitments", which includes residential mortgage exposures in <u>any</u> jurisdiction. UK branches of EU firms will be able to apply a lower conversion factor to UK mortgage commitments than domestic UK firms.

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Risk weight floor for commercial real estate (CRE).	Income-producing investment properties should be distinguished from business lending secured on commercial premises.	The 100% risk weight floor will not apply to CRE exposures that meet the "regulatory real estate" conditions and are not materially dependent on cashflows – i.e. own premises. This will apply to both SME and non-SME counterparties. All other CRE exposures will remain subject to a 100% risk weight floor.	The PRA expects this concession to decrease capital requirements for "own premises"' exposures relative to current rules. However, the UK rules will remain "Basel plus" for all other CRE and likely to increase capital requirements for higher LTV commercial mortgages that are not secured on own premises.	CRR3 implements BCBS standards for CRE. The EBA will review and report on the appropriateness of CRE requirements at a later date.
Application of the output floor.	Various views expressed, including level of applicability, hybrid SA-IRB rules (to help manage differences) and other easing measures.	The output floor calculation has been revised to adjust for the differences in how provisions can affect the CET1 resources of IRB and SA firms. No amendments have been made to the level of applicability or how the SA is calculated for output floor purposes. The PRA has not introduced additional easing measures and the phasing-in period for the floor has been shortened to 4 years – i.e. ending 31 Dec 2029.	Applying an adjustment for different treatment of provisions in the RWA floor formula avoids the complexity of alternative solutions, e.g. calculating pure SA and IRB capital ratios in parallel. While the implementation date has been delayed to 1 January 2026, no extra time has been granted for optimising balance sheets in response to the output floor.	CRR3 has introduced several transitional measures – in addition to the BCBS phase-in period – that are expected to ease the impact of the output floor (e.g. concessions for low risk mortgages). Some of the transitional measures that ease the output floor can be extended by the EU Commission, and subject to review and reporting by the EBA. It is possible that measures are extended or adopted into end-state in a future legislative proposal.

Policy issue	Industry viewpoint	Final proposal	Direction of change	Comparison with EU
SA mortgage valuation.	UK market trends for longer duration fixed periods might distort the policy rationale for maintaining value at origination.	To reduce operational complexity, the BCBS prudent valuation requirement (stable pricing over time) will not be implemented. To avoid affecting obligor incentives and behaviours, a five-year backstop is introduced on re-valuation events for residential mortgages. A 10% market valuation trigger has been specified for downward valuations. The PRA has also clarified that robust statistical methods may be used to determine valuation, which allows the use of indices or AVMs.	The five-year valuation backstop is more in line with UK trends for fixed-rate mortgages while maintaining the broad BCBS policy objective of constraining risk weight cyclicality. The BCBS prudent valuation requirement is more relevant to volatile housing markets – given the long-running stability of UK housing prices, its removal is unlikely to affect capital requirements and will avoid additional operational complexity.	CRR3 requires firms to value property at the higher of origination or: (1) six-year average for residential; (2) eight year average for commercial. The average is calculated at equal intervals, using at least three datapoints. However, this creates operational complexities (moving target), and potential interpretation issues for loans < three years. Both UK and EU rules adopt value at origination as a concept within valuation rules – differences in interpretation reflect UK and EU market specificities (e.g. the trend for longer fixed durations in the EU).
Granularity of risk weights for specialised lending.	Object finance specialists asked for greater risk sensitivity – e.g. adopting the "high quality" object finance sub class included in the EU's CRR3 framework.	No changes have been made to the treatment of object finance exposures, but definitions have been aligned between SA and IRB for object finance, project finance and commodities finance. The scope of eligible entities a counterparty relies on for the "high quality" project finance concession has been widened to align with those permitted under the withdrawn infrastructure supporting factor. For IRB firms, a new lower risk weight is available for the "substantially stronger" category for project finance.	Aligning SA and IRB specialised lending definitions will reduce operational complexity for IRB firms when calculating the output floor. Widening the eligible entities that counterparties rely on for "high quality" project finance is part of a package of measures aimed at compensating the withdrawal of the infrastructure. However, the overall benefit of these concessions will be linked to the outcome of the PRA's "structural lending adjustments" to Pillar 2A.	CRR3 includes a transitional allowance to apply an 80% risk weight to "high quality" object finance exposures until 31 December 2032. This transition was not included in the BCBS standards and the EBA is due to review and report at a later date.

Policy issue	Industry viewpoint	Final proposal	Direction of change	Comparison with EU
Loan splitting or whole loan approaches for SA mortgages.	Providing an option to use the BCBS whole loan approach for all mortgage exposures could facilitate operational/pricing simplicity, particularly for mortgage books concentrated in the "income producing" category.	No concession was made to the general principle (i.e. firms will not have an option). Additional risk sensitivity will be introduced for whole loan approach for regulatory residential exposures (in the 60%-80% LTV range). However, the PRA has clarified the application of loan splitting for second charge lending. Amendments to the definition of "materially dependent on cashflows" will also affect which exposures are treated under a split or whole loan approach.	The final rules broadly align with BCBS. However, changes to "materially dependent on cashflows" (which determines an exposure's treatment) will affect firms' impact assessments. Please see the "Digging deeper" section for more detail around "materially dependent on cashflows" classification. "Own premises" CRE exposures are likely to have lower capital requirements but simplification of the material dependency test for regulatory residential could capture a larger proportion of buy-to-let properties under the whole loan treatment, which will likely increase overall RWAs for affected firms.	CRR3 adopts the loan splitting approach for non-IPRE. However, the so-called "hard test" has been retained, allowing NCAs to neutralise the whole loan/higher RW for IPRE exposures.
Clarifications and additional guidance.	Despite enhancements to definitions, industry asked for clarification on several key terms to achieve regulatory compliance and consistent outcomes.	A number of drafting errors and inconsistencies have been corrected. Additional guidance has been provided in <u>some</u> areas (e.g. circumstances for re-evaluating currency mismatch). While several subjective points have been left open, the PRA has indicated willingness to give further guidance in areas where it observes significant inconsistencies in approach. Note that these further clarifications may not always be what industry anticipates.	While several helpful clarifications have been made, significant unanswered questions remain and may need to be addressed post-implementation, such as: • how to interpret "implicit government support" in the context of ECAI ratings; • how SA firms should calibrate adjustments if they feel ECAI ratings do not accurately reflect counterparty risk; and • how to determine eligibility for the preferential 100% risk weight for land ADC. Because the FSMA/PRA framework does not currently include a Q&A process, additional clarifications would require rule changes and/or new guidance in supervisory statements.	EU technical standards are still in development but are expected to provide much needed clarification in key areas not addressed in the CRR/CRD text. While changes to PRA rules/guidance require public consultation, the process is generally nimbler than amending EU level 1 or 2 text. However, the EBA Q&A process is used to harmonise supervisory practice and we expect this will be the primary mechanism for addressing post-implementation consistency.

Digging deeper

As is always the case with large, complex regulatory documents, the top-down view is important and informative, but the devil is in the detail. This package is no different. Some of the changes to the way the detailed, formal regulations are constructed (as set out in the 490+ page comparison of the draft and near-final rules) have potentially significant implications for some firms' portfolios.

Investigating the implications of one such detailed amendment as an example:

> Article 124E sets out how to determine if a residential real estate exposure is materially dependent on underlying cashflows (and so subject to higher risk weights and a more conservative RWA allocation method where the whole loan receives the risk weight based on the loan to valuation ratio of the loan).
>
> The way the rule is expressed has changed from "an exposure is materially dependent *if* the following tests are true" to "an exposure is materially dependent *unless* the following tests are true" – so moving from a base case that exposures are not dependent to a base case that exposures are dependent unless proven otherwise.
>
> For portfolios of residential mortgages, the implications are potentially very significant, particularly for those firms with portfolios of exposures that could be classified as materially dependent. One related clarification of significance is the PRA's "three property rule":
>
> - The PRA maintains its view that borrowers with more than three residential properties (not including their primary residence) represent a greater risk to lenders.
> - The PRA has clarified in the PS what lenders need to do to determine if a borrower has more than three properties, and the checks maintain the requirement for lenders to ascertain if the borrower has loans secured against properties with other lenders.
>   - Residential properties without loans secured against them would therefore not count.
> - The PRA also clarifies that each single housing unit that is a separate part within a multi-unit property counts as a property for the three property rule.
>
> Any borrower that exceeds the three property rule must have all their residential properties classified as materially dependent, other than those secured against their primary residence.

Lenders with significant portfolios of buy-to-let mortgages will need to review the PRA's revised rules for materially dependent exposures to ensure that the evaluations they have previously made as to which exposures are and are not captured as materially dependent remain accurate. To the extent that their assessments have changed, lenders will need to review their capital position/forecasts to ensure they are able to continue to meet minimum requirements and buffers.

For Basel programmes, the immediate priority will be undertaking a detailed review of the new draft rules to ensure that where detailed rule changes have broken the capital calculation flows for calculation engines, these are identified and amended as soon as possible.

Conclusion

The headline changes to the PRA's rules – the delay to the implementation date and "refunding" the SME and Infrastructure supporting factors in Pillar 2A will be welcome, albeit they come with some hooks – increased expectation of compliance arising from the delay and the need for firms to calculate the capital effect of the support factors and provide that information to the PRA in order to benefit from the Pillar 2 reversal.

Other changes are also positive (reduced CFs, SME property secured lending not subject to a 100% risk weight, “super-strong” risk weights for some slotting exposures) and demonstrate both the PRA’s willingness to listen to evidence-based arguments and its recognition of the importance of its secondary competitiveness objective.

There are, however, changes - including implementing HVCRE - which are negative. The effect of moving quasi-sovereign exposures into the non-modelled portfolios group will vary for different firms. And, in comes cases, the PRA has held its line in spite of considerable feedback, such as the treatment of unrated non-SME corporates, which will have significant effects on some firms’ balance sheets.

Adding in the effect of the detailed changes in the draft rulebook makes coming up with a clear view of the impact of the overall package on an individual firm extremely challenging. As always with such a varied set of industry participants, the impact of the PRA’s rules will differ for each firm according to its portfolio. That said, some of the changes around the real estate rules look set to affect firms with riskier CRE and materially dependent RRE exposures quite substantially. Conversely, firms that focus on trade and transaction-related finance will be feeling relieved: although they will not be better off than they are now, the prospect of significant increases in capital requirements has abated.

Firms adopting the Basel 3.1 package on 1 January 2026 have just over fifteen months and potentially a lot to do: an impact analysis of the revised rules to determine if they change any assumptions about post-Basel 3.1 strategic priorities or portfolio structure; and a full review of the regulatory interpretations that underpin their Basel 3.1 programmes in order to confirm that they remain appropriate as the basis for the design and implementation of the programme.

The clock is ticking…

Annex One: Key sections of the package

Credit Risk – Standardised Approach

A common thread to the key SA concessions has been sustainable growth and competitiveness, particularly in areas where industry-supplied empirical evidence supported different outcomes from the CP16/22 initial proposals.

- A notable industry success has been maintaining/lowering requirements for trade finance-related activities including:
  - reinstating the 20% conversion factor (CF) for transaction-related contingent exposures (including where these apply to exposures connected with the movement of goods within the UK); and
  - persuading the PRA to align with BCBS on a 40% conversion factor for "other commitments" not relating to UK residential mortgages.
- The Pillar 1 SME and infrastructure supporting factors will be withdrawn:
  - the PRA aims to minimise potential disruption to SME and infrastructure lending through "structural adjustments" to Pillar 2A. While this concession does not provide the same certainty as EU CRR3, and questions remain as to how the PRA will give practical effect to its intentions, this is indicative of the PRA seeking balance in pursuing its primary and secondary objectives.
- The final rules include adjustments that acknowledge differential risk characteristics of self-build mortgages and CRE exposures secured on "own premises":
  - for CRE exposures secured on "own premises", the 100% CRE risk weight floor will not be applied, unlocking potentially significant reductions in requirements for these exposures in comparison with the current UK CRR regime.
- A notable disappointment for many will be the PRA maintaining the 135% risk weight for non-SME unrated corporates assessed as non-investment grade:
  - the EU framework provides a transitional allowance for IRB firms (when calculating the output floor) to risk weight unrated investment-grade exposures at 65% until 31 December 2032, or otherwise apply a 100% risk weight – this is a clear gap in cross-border competitiveness. However, the PRA's 65% risk weight for investment grade exposures is a permanent concession and also available to SA firms (with permission);
  - in practice, we expect UK lenders will adapt by focusing on serving either investment or non-investment grade clients, although we note this could raise questions around competition.
- While the PRA has offered additional guidance in a few specific areas of ambiguity (e.g. reassessing the three-property real estate limit and re-evaluating income for currency mismatches), in many areas where respondents to CP 16/22 requested clarifications the PRA has chosen not to publish additional guidance:
  - the PRA has indicated that it will consider providing additional guidance if it observes significant inconsistencies in firms' application of the rules.

Credit Risk – Internal Ratings Based

In the main the final rules are very similar to those consulted upon. As well as dealing with the removal of the SME and infrastructure factors in Pillar 1 (as mentioned above) IRB firms will have to:

- implement the High Volatility Commercial Real Estate category in the slotting approach.
  - HVCRE definitions cover land acquisition for speculative purposes and where a change of planning use is sought for the property. The PRA further clarifies that one

of the characteristics of HVCRE is an exposure where the property has not yet been leased to the occupancy rate prevailing in that geographic market for that type of commercial real estate.
    - HVCRE risk weights are higher than IPRE slotting risk weights throughout the range of strong, good, and acceptable slotting grades.
    - HVCRE is not implemented in the EU, so this will be an area where the UK regime differs and UK firms may be disadvantaged against third country lenders.
- Implement a 0.1% PD floor for residential real estate exposures – as well as a 5% LGD floor.
    - The PRA has stuck to its approach here, in spite of feedback from industry that the existing regime is sufficiently conservative.
- Stop using continuous PD scales.
    - The PRA continues to be of the view that continuous PD scales give rise to lower risk weights due to the granularity of the risk weight function, but that are not justified by actual risk differentiation between obligors.
- Add quasi-sovereign exposures to the exposure types that are no longer allowed to use the IRB approach.
    - The PRA, based on feedback received through the consultation process, takes the view that the modelling of quasi-sovereign exposures presents similar challenges to those of modelling sovereign exposures, and so will add quasi-sovereign exposures to the list of portfolios for which the standardised approach is the only permissible way of assessing RWAs.
    - The PRA will review the overall RWA regime for sovereign and quasi-sovereign exposures as part of its upcoming Pillar 2 review.

However, there is some good news for IRB firms:

- The 1.25 multiplier to the correlation factor that applies to exposures between financial institutions will not have to be applied to exposures to the treasury operations of corporate borrowers (as long as they only act on their own behalf).
    - Corporate treasury operations will therefore also be able to be rated under the AIRB regime, as long as they fall below the size threshold.
- Firms will be able to recognise undocumented support from parent entities.
    - CP16/22 proposed that in order to recognise support from a parent entity, firms would have to have a document in written form setting out the support.
- Firms will not have to identify "credit facilities that would not otherwise be captured as off-balance items" and apply a CF to them,
    - CP16/22 proposed that, because of the changes to the definitions of commitments and the restrictions on the use of Exposure at Default (EAD) modelling, firms would have to incorporate potential drawings that took obligors overdrawn against facilities that had no limit or were otherwise not captured as off-balance sheet items.
    - The existing requirement for AIRB firms to ensure that their RWAs reflect instances where obligors without agreed limits are overdrawn at default will remain.
- "Substantially stronger" categories in IPRE and Project Finance will allow for lower risk weights for those exposures that are demonstrably lower risk than the norm in those markets.

Credit Risk Mitigation

There are a few helpful clarifications and amendments to the CRM section of the rules, including:

- clarification of the conditions to recognise collateral provided in support of a guarantee where the guarantor is not an eligible guarantee provider;

- allowing recognition of collateral provided against exposures under the slotting approach, provided that there is no double-counting of the collateral (in the security section of the slotting approach); and
- clarification that real estate valuations can be provided by an automated valuation method (AVM)

Output Floor

The main amendments to the output floor are:

- to change the calculation slightly so as to incorporate the effect of the IRB EL/Provisions test into the output floor; and
- to revise the transitional timetable to retain the end-date of 31 December 2029 given the further change to the implementation date for Basel 3.1.

Pillar 2:

For a publication that is ostensibly focused on Pillar 1 requirements, it is notable that some of the most important action will take place in Pillar 2.

- As mentioned above, the PRA plans to mitigate the removal of the SME Supporting Factor and Infrastructure Supporting Factor via adjustments to firms' Pillar 2A.
    - Uncertainties remain over how the "SME lending adjustment" and "infrastructure lending adjustment" will work in practice, and by moving the adjustment into the Pillar 2 framework (rather than baking it into the Pillar 1 framework) the PRA retains a degree of discretion and control over its effect.
    - In order to benefit from the adjustment firms will be required to submit data to the PRA as part of an off-cycle review of firm-specific Pillar 2 capital requirements. The PRA does not specify how firms would continue to benefit from the adjustment beyond "day 1", but it seems reasonable to assume that firms would have to provide the data as part of their ICAAP process on an ongoing basis.
    - Firms will need to weigh up whether the prospect of capital relief is worth the additional operational burden of assessing their exposures against the criteria for the adjustment factors and submitting data to the PRA. This will vary from firm to firm depending on their business model, but for the infrastructure supporting factor in particular, given the burdensome process to assess exposures against the criteria for applying the factor, uptake may be limited to a small sample of firms that specialise in infrastructure finance. With this being the case, the aggregate effect of two of the PRA's headline concessions could be relatively limited.
- The PRA will rebase firms' Pillar 2 requirements (and adjust requirements to avoid double counting or unwarranted mechanical increases), through the off-cycle review conducted over the course of 2025. More fundamental change to the PRA's Pillar 2 methodologies (i.e. changes that go beyond addressing the consequential impact of Basel 3.1) may come after Basel 3.1 is finalised.
- The PRA included in its raft of publications a consultation paper on streamlining the Pillar 2A framework.
    - The most consequential proposal was to retire the "refined methodology" introduced in 2018 whereby supervisors adjust certain firms' aggregate Pillar 2A add-on to mitigate unwarranted conservatism in standardised RWAs compared to IRB RWAs. The PRA's view was that, given the narrowing of the gap between the outputs of the two frameworks under Basel 3.1, the capital impact of retaining the refined methodology is not worth the operational burden of doing so.

Pillar 3 and Reporting

The changes made to the Pillar 3 and Reporting sections of the PS were principally in response to requests from industry for clarifications and improvements to consistency of reporting – which the PRA has responded to by updating the templates and instructions that are attached as appendices to the PS.

On the subject or reporting, the PRA points out that it plans to "…*review the full range of bank reporting data it collects with a view to making improvements and efficiencies*." Some of the points raised around reporting will be addressed during this process, however in the interim the PRA is looking to align its reporting framework with BCBS expectations.

Consultation on the SDDT simplified capital regime

Alongside the Basel 3.1 package discussed above, the PRA consulted on the capital elements of the SDDT regime (CP7/24). This follows the Policy statement (PS15/23) on scope, liquidity, and disclosure specification for the regime, which came into force earlier in 2024. The Consultation includes simplifications to the Basel 3.1 regime for SDDT-eligible firms, including minor changes to the Pillar 1 capital calculations, and quite significant streamlining of the Pillar 2A, reporting, and capital buffer structure requirements.

The proposal would allow SDDT firms to apply the new capital regime from 1 January 2027. In the year between Basel 3.1 implementation and when the new capital parts of the SDDT regime apply, firms entering the SDDT capital regime will follow the current CRR standards (Interim Capital Regime), to avoid having to apply the more complex Basel 3.1 standards for only a year.

Authors and contacts

David Strachan

Advisor

EMEA Centre for Regulatory Strategy, Deloitte UK

dastrachan@deloitte.co.uk

Rod Hardcastle

Director

EMEA Centre for Regulatory Strategy, Deloitte UK

rhardcastle@deloitte.co.uk

Sinead Rothwell

Partner

Risk Advisory, Deloitte UK

srothwell@deloitte.co.uk

Liam Girvan

Associate Director

EMEA Centre for Regulatory Strategy, Deloitte UK

lgirvan@deloitte.co.uk

Alex Spooner

Manager

EMEA Centre for Regulatory Strategy, Deloitte UK

apspooner@deloitte.co.uk

Luca Pagani

Senior Consultant

EMEA Centre for Regulatory Strategy, Deloitte UK

lpagani@deloitte.co.uk