# Basel 3.1 – Redefining the credit risk landscape

January 2023

# Executive summary: Basel 3.1 – Redefining the credit risk landscape

On 30 November 2022, the Prudential Regulation Authority (PRA) published Consultation Paper (CP) CP16/22 – Implementation of the Basel 3.1 standards ('CP16/22'), which sets out its proposed implementation of the finalised Basel III standards in the UK (referred to as the 'Basel 3.1 standards').

The PRA's draft rules are largely aligned to the Basel standards, in contrast to those of its EU counterparts, which propose significant deviations. The UK regulator has, however, proposed super-equivalence in some areas where further discretion has been used to tailor the proposed implementation of the reforms to address UK-specific risks.

Whilst industry focus may be on understanding the steps needed to comply with the new rules, this paper takes a different perspective by stepping back and reflecting on the wider market and strategic implications of the proposals.

**The credit risk proposals are expected to result in a fundamental rebalancing of, and change in, the competitive landscape. They will require banks and building societies (collectively, 'firms') to reconsider their strategy and portfolio mix to ensure optimal use of capital and to maximise profitability. At the same time, robust and efficient operational capabilities will be required to achieve compliance cost effectively.**

**We have distilled the key impacts of the PRA's credit risk proposals into the following three themes:**

**Changing the competitive landscape**

- The PRA's proposals are set to redefine the UK banking sector's competitive landscape.
- The proposals are expected to open up certain lower risk segments to mid-tier firms, whilst also encouraging larger lenders to pursue certain higher risk segments.
- The market structure is expected to fundamentally change from a relatively concentrated model to a more diversified model where large and mid-tier firms may operate in overlapping segments.

**Necessitating greater optimisation of capital**

- There are a number of key 'winners' and 'losers' across portfolio segments as a result of these proposals.
- Firms should optimise the use of capital by strategically considering levers such as risk appetite, capital allocation and pricing to remain competitive.
- The output floor may have a significant impact, although our illustrative analysis suggests the floor is unlikely to impact most credit-risk focused firms due to the general convergence of risk weights.

**Adding to the operational challenge**

- Approaches to capital planning and risk-based decisioning will need to be redefined to effectively tackle the dynamic capital optimisation problem.
- End-to-end reporting processes and controls will need to be reviewed to allow for dual reporting requirements.
- This may be the right time to invest in robust solutions to support the comprehensive, granular and complete data required and assess where enhancements to business processes will be required.

## Key takeaways and considerations for firms

The credit risk proposals are expected to change the competitive market landscape by (i) introducing a revised set of granular risk weights (RWs) under the Standardised Approach (SA); (ii) constraining the use of modelled approaches and model inputs under the Internal Ratings Based (IRB) approach; and (iii) ultimately, reducing the variation in RWs across SA and IRB (whilst making IRB more accessible).

In the short-term, firms should perform a thorough assessment of the impact of the proposals on their portfolios and operations. As we outline in this paper in more detail, there is an opportunity for firms to implement the proposals more strategically by re-evaluating relationships between risk appetite, pricing and portfolio composition in a post-output floor world.

Furthermore, there may be material implications on business cases for and roll-out plans under IRB. Firms must therefore re-assess their internal model strategies to ensure these remain beneficial.

We also expect there to be significant operational complexity in implementing these reforms across numerous risk, finance and commercial processes. To meet these challenges, especially in light of the current scrutiny, firms should consider investing in robust solutions to support the more comprehensive and granular data required for regulatory reporting.

# Taking a more strategic look at the Basel 3.1 credit risk reforms

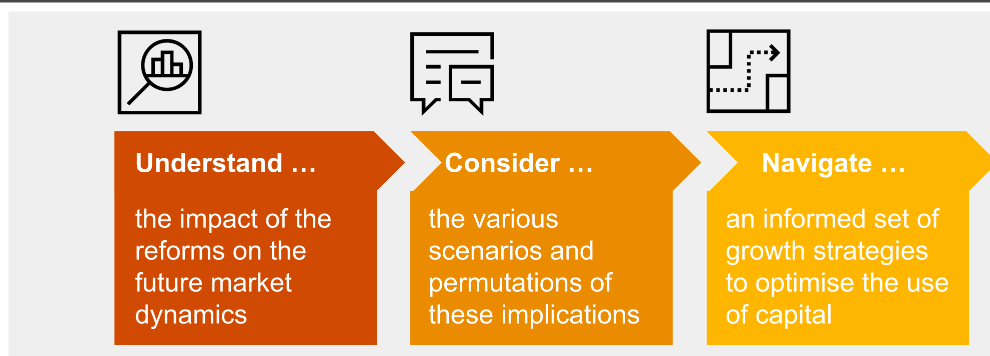
The credit risk proposals set out in CP16/22 have three key aims: (i) reducing unwarranted variability in risk-weighted assets (RWAs); (ii) improving the risk sensitivity of the SA; and (iii) introducing safeguards via capital floors to avoid excessively low capital requirements resulting from internal models.

Salient proposals from a credit risk perspective include:

- A more risk sensitive SA, particularly for the residential real estate (RRE), qualifying revolving retail exposure (QRRE), unrated corporates and specialised lending project finance segments;
- A series of changes to reduce variability in IRB risk weights (RW) across firms, including:
  - Parameter level input floors, including a further uplift of the 0.05% probability of default (PD) floor under Basel proposals to 0.10% for exposures secured by mortgages on UK residential property;
  - Changes to the permitted scope of IRB, including removal of IRB for sovereign exposures; and
  - An output floor constraining the overall RWA benefit of internal models, set at 72.5% of the aggregate standardised RWAs across all risk types.
- Amended thresholds for IRB accreditation, including a reduction from 'full' to 'material' compliance, and the removal of the 'full-use' requirement for IRB, including the 85% RWA threshold for roll-out coverage.

The proposals include a five-year phase-in of the output floor; however, the PRA has not proposed extensive transitional provisions and review clauses as in the EU.

**The proposed reforms represent the most significant regulatory changes in the capital space in the past 15 years. Naturally, there will be challenges for firms in implementing these changes; however, their far-reaching nature also presents an opportunity for firms to tackle implementation in a holistic manner, as set out below, understanding the key strategic implications for their portfolios and growth plans.**



This paper looks to help firms start this journey by providing our reflections on the 'Understand' step and three specific thematic implications of these proposals.

**The following pages explore each of these themes in more detail and provide some illustrative analysis of RW impacts under certain scenarios (including the output floor).**

**Changing the competitive landscape:**
Firms should consider expected changes to the market structure and the potential for increased competition between SA and IRB firms

**Necessitating greater optimisation of capital:**
Firms should strategically tackle the revised capital optimisation problem to maximise profitability and optimise use of capital

**Adding to the operational challenge:**
Firms should expect widespread operational impacts of the reforms across a number of risk, finance and commercial processes

# Changing the competitive landscape

Since the global financial crisis, there have been a number of new entrants into the UK banking sector. These new entrants ('challenger banks') have provided consumers with an alternative banking service to traditional lenders, changing the competitive landscape. However, RW imbalances have constrained them from competing effectively with larger IRB firms in certain market segments and pushed them towards previously underserved markets.

In accordance with its secondary competition objective, through its proposed implementation of Basel 3.1, the PRA appears to build on existing initiatives to continues to facilitate effective market competition. This includes providing a choice to non-systemic firms, via the proposed 'Strong & Simple' regime, to continue applying current rules rather than implementing the Basel 3.1 regime. Nonetheless, the proposals in CP16/22 have the potential to shake up the competitive market landscape and create a 'dynamic equilibrium' with a number of firms - both large and small - likely to consider changes in risk appetite, portfolio composition and pricing in response. Understanding these dynamics will be important in ensuring firms remain competitive and profitable through optimal deployment of capital.

There are two key dynamics that firms will need to consider in relation to the changing competitive landscape and the wider economic uncertainty (e.g. Brexit challenges, and the high-interest rate and rising inflation environment):

### Minimising divergence of credit RWs

The proposals seek to reduce variation in credit risk weights across firms. This includes both minimising unwarranted divergences between IRB and SA RWs, and also reducing divergences in RWs across IRB firms.

The proposals can be segmented into the following:

- Introduction of **more granular and risk-sensitive** SA RWs, with significant changes for the RRE, QRRE and unrated corporate exposure classes;
- Introduction of **input parameter floors** and **limitations to the use of internal models**; and
- Introduction of an **aggregate output floor across risk types**, phased in over a five-year period, such that RWAs at Group level must be at least 72.5% of the SA equivalent.

These influences will lead to a reduction in divergence of RWs across firms, as illustrated through our quantitative analysis on the following page.

### Greater accessibility of IRB accreditation

The PRA is increasing accessibility of the IRB approach through two key proposed changes to the thresholds for IRB approval:

- Reduction of the threshold for IRB approval from 'full' regulatory compliance to 'material' compliance, for consistency with treatment of firms with existing permission (i.e. who are not required to remediate immaterial areas of non-compliance).
- Removal of the 'full use' requirement, including the 85% RWA threshold for IRB roll-out coverage. The key components of this proposal include:
  - A simpler, more transparent approach for determining which exposure classes to roll-out to IRB, with the principle being to minimise 'cherry-picking';
  - Permitting permanent use of the SA within a roll-out class in certain circumstances, although at least 50% of total group credit RWAs for each roll-out class are required to be IRB.

The reforms will potentially open up a number of lower risk segments to challenger banks where they were historically uncompetitive. In a similar vein, depending on where established firms are with their capital headroom and output floor, they may encourage these lenders to pursue higher risk segments.

Essentially, the market structure will fundamentally change from a concentrated model, where high-street lenders are focused on the lower risk segments and challenger banks focused on traditionally underserved higher risk segments, to a more diversified market model where large and mid-tier firms may operate in more overlapping segments leading to a 'dynamic equilibrium' in the market structure.

This will naturally have direct consequences on a firm's portfolio strategy and product pricing (requiring them to be agile), which are considered in the next section.

# Changing the competitive landscape: *Illustrative analysis – RRE and IPRRE*

The below analysis illustrates the RW impacts of the PRA proposals for residential mortgages. For the purposes of this analysis, we have considered RRE and IPRRE (Income Producing RRE) separately, and assumed the RW impact of the Basel 3.1 IRB changes is net neutral.

We have considered two hypothetical portfolios, with loan-to-value (LTV) distributions reflective of prime and near-prime portfolios, respectively. The portfolio average IRB RWs shown in the table are based on current rules (post hybrid-PD) and are provided as context to illustrate the portfolio quality.

| Metric | Prime | Near-prime |
|---|---|---|
| Average LTV | 45% | 54% |
| RRE RW | 14% | 22% |
| IPRRE RW | 19% | 29% |

## Illustrative analysis performed

**Change 1: Greater risk sensitivity of SA RWs for RRE and IPRRE exposures**

The SA RW changes for the RRE and IPRRE exposure classes are illustrated in Figure 1.

**Change 2: The LTV used to determine SA RWs will be based on origination valuations**

Simple additive shifts have been approximated assuming uniformly distributed exposure, i.e. a 2% LTV uplift moves 20% of the balance in the 50-60% LTV band into 60-70%. The impact is considerable, but small relative to the broader RW changes (i.e. the difference between 'Current' and 'Proposed' in Figure 2).

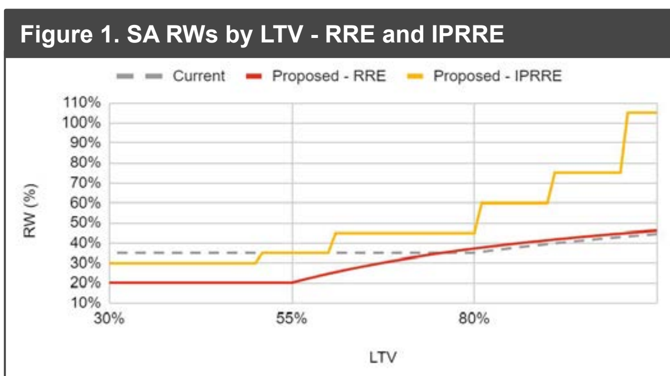


Figure 1. SA RWs by LTV - RRE and IPRRE

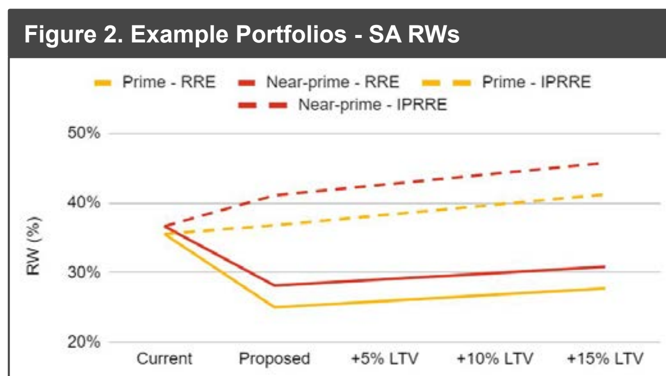


Figure 2. Example Portfolios - SA RWs

## Indicative results and implications

More risk-sensitive SA RWs and floors in the IRB framework will both enable SA firms to hold a level of capital more reflective of underlying risk, and reduce the imbalance between IRB and SA RWs. Our analysis shows the following:

- **Owner occupied:** For our two hypothetical portfolios, SA RWs reduce from 35-37% to 25-30%, with the exact impact depending on the magnitude of the increase in LTVs due to use of origination LTV under the new SA.
- **Buy-to-let:** There is a much wider range of potential outcomes. Portfolios with lower LTVs and/or a limited proportion of portfolio landlords may see a decrease in SA RWs, whereas high-LTV portfolios and/or portfolios concentrated in IPRRE or commercial properties (e.g. holiday lets) are likely to see an increase.

Indicative ranges for the ratio of IRB to SA RWs are illustrated below. The ratio of IRB to SA RWs is likely to be at least c.50% (A) under the proposed approach for both RRE and IPRRE (compared to as low as 25% for RRE pre-Hybrid PD, B), and this ratio is now more consistent across LTV values.

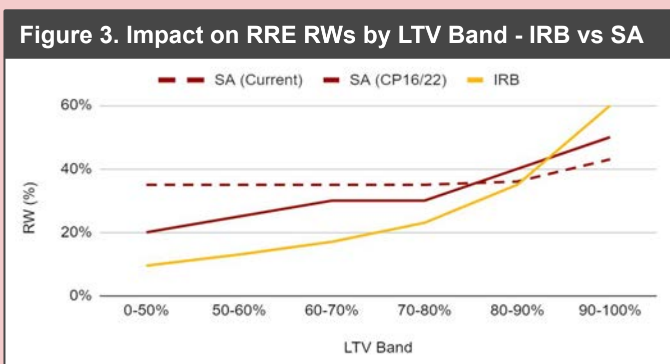


Figure 3. Impact on RRE RWs by LTV Band - IRB vs SA

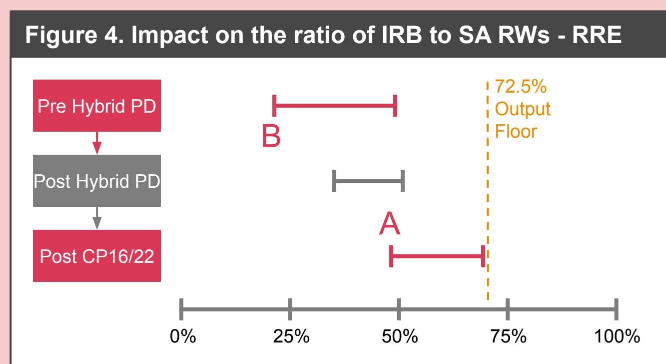


Figure 4. Impact on the ratio of IRB to SA RWs - RRE

# Necessitating greater optimisation of capital

The PRA's proposals carry long-term significance for capital allocation and management across the industry. This is particularly true of the rebalancing of risk-weights across portfolio segments for both IRB and SA, and of the output floor. We expect these changes to translate into a shift in the relative attractiveness of certain exposure classes and market segments and potentially drive a strategic rebalancing of firms' portfolio composition.

This section explores some of the key changes in this regard, and considers which portfolio segments stand to be most affected. The proposals in CP16/22 are not expected to result in fundamental changes to firms' current capital planning processes (bar the introduction of a binding output floor for firms with modelled approaches); however, the far-reaching changes across SA and IRB RWs mean that all firms now have to tackle a far more complex portfolio allocation and RWA optimisation problem.

For firms expected to be impacted by the output floor, there may be an opportunity to review strategic portfolio composition, risk appetite and future growth objectives to optimise capital requirements. Firms will need to consider how to achieve the desired portfolio mix, including acquisitions or sell-offs where significant changes are targeted. Organic growth is likely to be sufficient for most firms given transition timelines.

Firms may need to determine adjustments to:

**Portfolio composition:** Will the attractiveness of certain exposure classes or segments of the market be significantly altered?

**Risk appetite:** Do the revised capital requirements result in changes to the firm's risk appetite? Are new risk appetite statements or metrics required to reflect the new requirements?

**Pricing:** Are adjustments to pricing for certain exposures or market segments required to ensure continued profitability and competitiveness?

The graphic below illustrates a selection of portfolios or segments we expect to be the significant winners and losers as a result of the PRA's proposals (on an individual basis - the output floor is considered in detail in the impact analysis on page 8), and present detailed considerations on the following page for a selection of exposure classes.

For the remaining classes, we expect the capital impact of the changes either to be broadly net neutral (e.g. for sovereigns, where removal of IRB may be offset by a Pillar 2 impact), or to be immaterial for most firms (e.g. due to limited exposure, or more niche changes). Key 'winners' and 'losers' from the exposure classes in focus are highlighted below. Broader consideration should also be given to the PRA's Pillar 2 framework and offsets permitted as part of this.

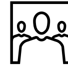
| | Retail | Wholesale |
|---|---|---|
| **Winners** ✓ | • Prime residential mortgages (SA)<br>• Social housing exposures (SA)<br>• 'Transactor' credit cards (SA)<br>• Residential development finance with substantial pre-sale or pre-lease agreements (SA) | • Investment grade (IG) unrated corporates (SA)<br>• High quality project finance in the operational phase (SA)<br>• Residential development finance with substantial pre-sale or pre-lease agreements (SA) |
| **Losers** X | • Retail SMEs (SA and IRB)<br>• High LTV second charge and limited company mortgages (SA)<br>• Portfolio landlord, houses in multiple occupation (HMO), care home, student accommodation & holiday let mortgages (SA)<br>• Prime residential mortgages (IRB) | • Sub-investment grade unrated corporates (SA)<br>• Corporate SMEs (SA and IRB)<br>• Project finance in the pre-operational phase (SA)<br>• Financial corporates and large corporates (IRB) |

# Necessitating greater optimisation of capital (continued)

The winners and losers shown on the previous page reflect some of the key changes across a range of exposure classes and the possible implications for various market segments. The boxes shown below provide further insights on potential impacts of the underlying changes across some of the exposure classes with significant changes.

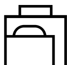
## Mortgages

- High IPRRE RWs may result in a shift away from lending to portfolio landlords (towards landlords with fewer than four properties, which can be treated as RRE). Alternatively, this may be adjusted for through higher pricing.
- There is potential for innovations such as conditional pricing linked to a borrower taking a fourth mortgage elsewhere.
- Other segments significantly less attractive under the proposals include properties now classified as commercial (e.g. care homes, student accommodation, holiday lets), and HMOs and second-charge mortgages.



## Unsecured retail

- Given IRB firms typically already have higher RWs for QRRE, the proposed preferential RWs under SA for transactors will further the competitive advantage of SA firms in this segment.
- Larger firms may use this to offset the impact of the output floor, or could look to reduce exposure, creating an opportunity for SA firms to consolidate portfolios.
- Some IRB aspirant firms may be cautious growing this segment, given the expectation that material QRRE portfolios will have to be rolled out to IRB and may therefore reduce the overall financial benefits of a potential transition to IRB.



## Corporates

- IRB firms are expected to be well placed to obtain PRA permission to distinguish IG and Sub-IG unrated corporates, and may benefit from lower RWs for the IG segment for output floor purposes.
- SA firms potentially have less mature credit assessment processes to distinguish between IG and sub-IG corporates and therefore will have greater barriers to obtaining this benefit. This may also lead to greater incentives to consider internal models if the potential benefit is significant.
- Removal of the SME supporting factor is expected to increase the cost of capital for lending to such segments, notwithstanding any offsetting Pillar 2 impacts.

## Specialised lending

- Firms will have to separately identify and report on object, commodities and project finance exposures under the SA, necessitating a change in exposure classification policies and identification processes.
- Given potential for lower RWs, firms may look to revise lending standards, documentation and processes to evidence that operational-phase project finance exposures are 'high quality'.
- Some firms will need to roll-back models or revise roll-out plans given slotting is the only proposed approach for income-producing real estate (IPRE) and high-volatility commercial real estate (HVCRE), whilst HVCRE will also be hit with higher risk weights, potentially impacting pricing.

# Necessitating greater optimisation of capital: *Illustrative output floor analysis*

The illustrative analysis outlined below assesses the potential impact of the proposed output floor, which could have significant implications for an impacted firm's strategic portfolio composition.

## Illustrative analysis performed

**Change: An output floor is proposed at 72.5% of aggregate RWAs determined on a standardised basis**

The narrowing of the gap between IRB and SA risk weights considerably mitigates the impact of the output floor. However, the floor will impact firms with concentrations in segments with large IRB benefit and/or significant internal model coverage (including across multiple risk types). To assess the floor's impact, we have performed analysis on a range of firm profiles, and have presented an example firm likely to be impacted.

We have assessed the impact for the following example portfolio composition:

- An IRB lender heavily focused on prime residential mortgage lending;
- The majority of exposure is in residential mortgages (of which 75% RRE and 25% IPRRE);
- Diversified corporate exposure, with a considerable proportion of unrated corporates; and
- Credit risk comprises 85% of total RWAs, with the remaining 15% calculated using standardised approaches.

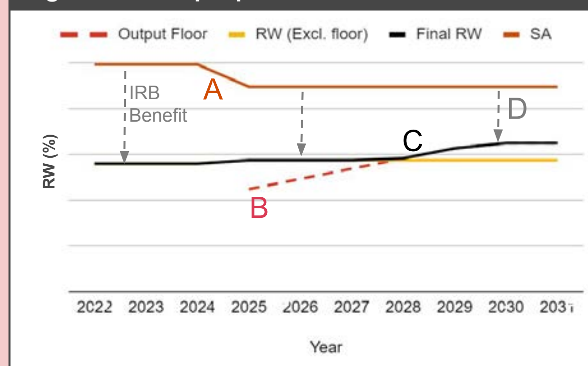
**Figure 5. Example portfolio – credit exposure**

## Indicative results and implications

**Figure 6 forecasts portfolio RWs over a ten year period for the example firm. Key observations from the graph include:**

A. Significant reduction in SA RWs after implementation of CP16/22, driven by lower RRE SA RWs;
B. Implementation of the output floor from 2025, increasing from 50% to 72.5% over the transition period;
C. Slight increase in final RW level in 2025 (PD input floor) and when the output floor become binding in 2029; and
D. IRB RW remains considerably below the SA, although the extent of the benefit has reduced.

**Figure 6. Example portfolio RW forecast**




Under current rules, some firms hold IRB RWs that are a fraction of the SA equivalent, particularly for low LTV RRE exposures and unrated corporate exposures, which would likely fall well below the 72.5% level.

However, the reductions in SA RWs for these segments, combined with increases to IRB RWs, have considerably raised this ratio. As a result, the following factors are likely to limit the impact of the output floor:

- Benchmarking suggests even the best quality mortgage portfolios are likely to produce RWs under IRB of at least c. 50% of the SA RWs – for near prime, this ratio is closer to 65%. Similar ratios are present for corporate exposures, where segments with the largest benefit from IRB historically are expected to see a reduction due to additional risk-sensitivity in the SA (e.g. unrated corporates) and restrictions on the use of Advanced IRB.
- Most firms have a reasonable proportion of their total RWAs calculated under standardised approaches (e.g. for operational risk), which reduces the implied IRB floor below the overall 72.5%.
- Certain exposure classes (e.g. QRRE) typically have higher RWs under IRB than SA, which will provide an offset against other IRB portfolios in the calculation of the output floor.

Where the output floor is binding, this may create a dynamic whereby firms would benefit from higher returns on capital through strategic changes to portfolio mix or risk appetite (i.e. pursuing riskier portfolios).

The impact of the floor can be reduced by reweighting the portfolio mix towards products or segments where the IRB RW ratio exceeds 72.5%. In practice, this typically correlates to higher risk lending; however, changes of this nature may be limited by broader constraints, such as Pillar 2 and leverage ratio requirements, and market factors.

# Adding to the operational challenge

Over recent years, there has been an increased focus on the reliability of regulatory calculations and reporting, with the PRA outlining its expectations in various 'Dear CEO' letters, enforcement notices, and via increased use of Section 166 reviews. Against this backdrop, firms have recognised the need for robust and dynamic regulatory reporting processes and are investing in enhancing governance, data, and infrastructure solutions supporting capital calculations and reporting.

The Basel 3.1 reforms propose significant modifications to the way firms must calculate and report on their capital requirements. These changes provide firms with an opportunity to review their existing capital calculation/reporting and broader business/risk management processes (e.g. capital planning, risk appetite, portfolio management) with a view to continuing to optimise and future-proof these. However, implementation timelines will be compressed, which may necessitate the use of tactical solutions. This challenge is accentuated for firms using advanced approaches who will have to build parallel standardised capabilities for output floor purposes.

## What does this mean for firms operationally?

### 1. Redefine approaches to capital planning and business/risk decision making in order to effectively tackle the revised capital optimisation problem

- Firms can no longer rely upon simplistic approaches and assumptions in pricing, business and capital planning, and risk appetite calibration given greater risk sensitivity in SA and the introduction of the output floor.
- Granular risk-based pricing and loan structuring tools may be needed, both to maximise return on capital and to incentivise certain customer behaviour, such as obtaining credit ratings or more frequent mortgage refinancing.
- Capital planning and risk appetite frameworks may also need to be enhanced to allow for consideration of strategic choices and portfolio composition sensitivities in a greater level of detail, balancing multiple factors.
- Firms should look to re-assess IRB model cost-benefit analyses considering updated capital impacts, model development and maintenance costs, and wider benefits and make choices on the scope of IRB given the proposed removal of the 'full use' requirement.

### 2. Review end-to-end reporting process and controls to support increased (or dual) reporting and disclosure requirements

- The output floor requirements mean many firms with modelled permissions will have to calculate and report under the standardised approaches for the first time in over 15 years.
- Parallel reporting requirements effectively double both the upfront and ongoing operational burdens, with firms required to undertake all elements of the end-to-end implementation process – from data scoping, sourcing and interpretations, to process and controls design – as well as governance, on two separate and fundamentally different bases.
- The increased operational burden underscores the need to deploy more efficient automated solutions, and firms may use this as a chance to retire legacy systems and end-user computing tools that are no longer appropriate.
- At the same time, the PRA's increased scrutiny over regulatory reporting is expected to continue, further emphasising the need to ensure effective governance and controls over more granular external reporting.

# Adding to the operational challenge (continued)

## 3. Invest in robust solutions to support the more comprehensive, granular and complete data required for capital calculations and internal and external reporting

- Basel 3.1 implementation provides an opportunity for firms to review their data models and develop holistic strategies for ensuring data granularity, completeness, accuracy and availability.
- Firms with historical data limitations, including in relation to traceability and data quality controls, will have greater challenges given the complexity of data attributes required under the revised calculations and will be expected to make reasonable efforts to access required data and develop strategic solutions.
- Alignment with broader strategic priorities, such as implementation of cloud-based solutions, data lakes and enhanced data consumption models and visualisation tools, should be at the forefront.
- Firms should look to work proactively with third-parties in cases where market-wide data solutions may be necessary (such as in relation to the number of buy-to-let mortgages a borrower has across the market).

## 4. Assess where enhancements to existing, or implementation of new, business processes will be required, from due diligence on external ratings to real estate collateral valuations

- Pragmatic and proportionate solutions for performing annual due diligence on the risk profile and characteristics of all counterparties under the SA will be required to manage operational burden and cost.
- Firms will need to demonstrate more comprehensive due diligence frameworks are in place to obtain PRA permission to risk weight unrated corporates based on their internal creditworthiness assessments, which is likely to require organisational structure changes for firms without existing corporate credit functions.
- Cost-effective ways to obtain comprehensive real estate collateral valuations should be identified, with the PRA reiterating that valuations shall be performed by independent and suitably qualified valuers.
- The need for Risk and Finance functions to work together collaboratively will become more important than ever, necessitating improvements in communication across teams and functions to support key processes.
- A firm-wide training strategy may also be required to ensure all functions are equipped to discharge their responsibilities, whilst in some cases the use of vendors and managed service providers may be necessary to resolve capacity gaps.

# Reflecting on the key takeaways

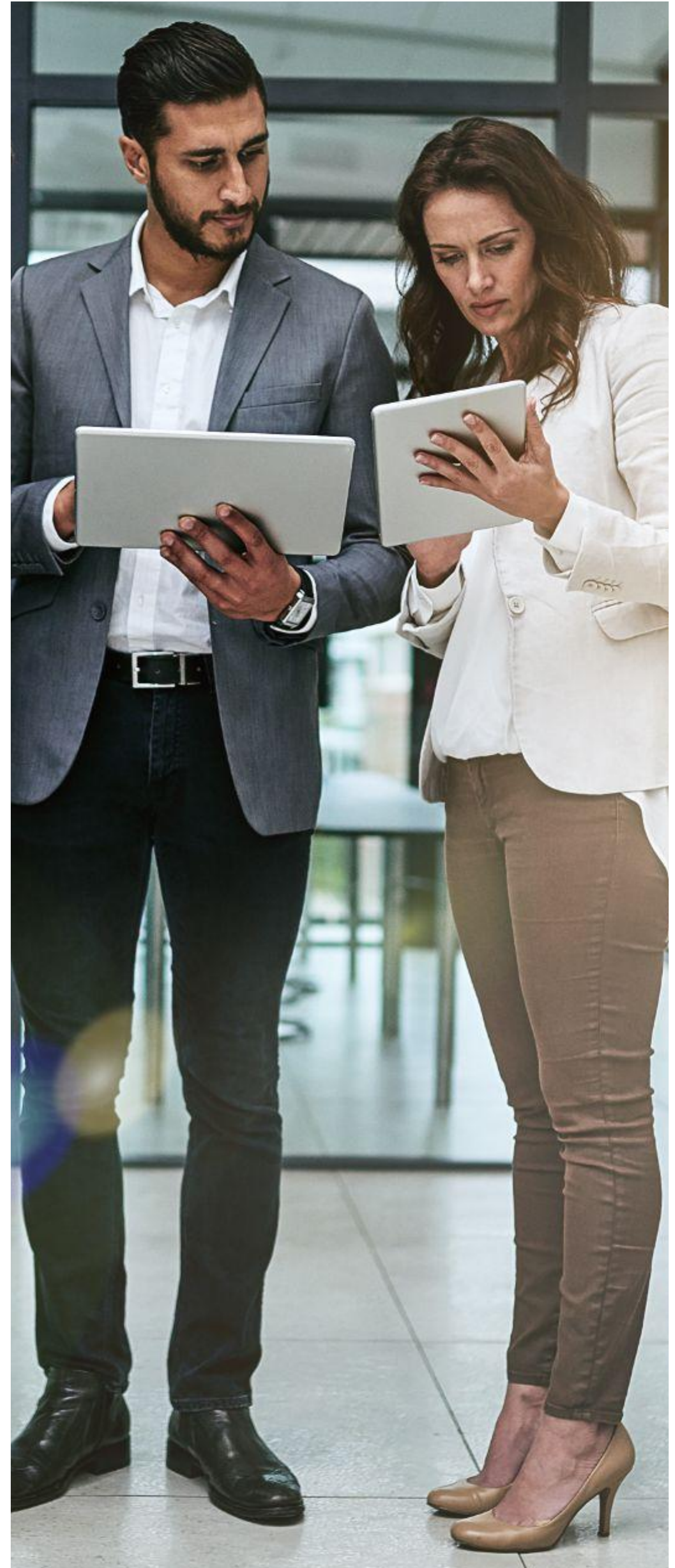
**The Basel 3.1 proposals represent the most significant regulatory capital change for the last 15 years, with the potential to shift both the competitive market environment and internal dynamics firms face in balancing strategic growth with capital efficiency. Firms should focus on assessing the impacts of the changes on capital, operations and model strategy in the short-term, before turning to implementation.**

Given the complexity and vast interplays inherent within the proposed reforms, it is essential that firms **perform a thorough impact assessment in the context of their portfolios and consider the broader strategic implications** of the proposals in parallel to a implementation and compliance planning exercise. By performing this assessment in the short term, firms will be able to identify any strategic adjustments required early and implement these in a phased manner over the transition period (i.e. until 2030).

A rebalancing of RWs of this nature will also have far-reaching implications on, and may require corresponding changes to, firms' risk appetite, pricing and portfolio composition in order to maintain competitiveness and profitability. **Working through these changes, together with managing the dynamic equilibrium of market competition in a post-output floor world, should be a key focus area** over the short-to- medium term. Naturally, the first step to this is to understand the impacts and then expand to what these mean across the wider business, risk and commercial processes notes.

For certain portfolios, there **may also be material implications in terms of the business case for IRB and the associated impacts on future capital requirements**. Several elements of the proposals will influence the cost-benefit analysis of utilising internal models. On the one hand, the output floor reduces the potential capital benefit from achieving IRB approval. On the other, changes in the SA RWs, and more flexible partial use rules, may incentivise firms to pursue IRB accreditation.

Notwithstanding the broader advantages to risk management, firms **must assess their internal model strategies to determine if deploying models (and incurring the additional operational cost) would be beneficial** given their existing permissions, portfolio composition, and business model.



# How we can help you prepare for the post-Basel 3.1 world …

**… to support you in maximising your strategic potential through regulatory compliance.**

The regulatory landscape for firms continues to evolve. We have first-hand experience supporting firms in unlocking their potential and accomplishing their strategic goals.

We bring the latest analysis on emerging risks via our tools and accelerators and insight into key regulatory developments impacting the UK IRB framework to help keep you ahead of the evolving regulatory landscape.

## Utilise the PwC Basel 3.1 Digital Suite and thought leadership

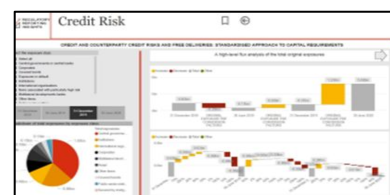
**Basel 3.1 RWA impact assessment tool:**

The RWA impact assessment tool can support your strategic impact analysis, by providing quantitative insights into how the proposals would impact your aggregate RWA capital levels under a range of scenarios.

**Regulatory reporting insights tool:**

This is a cloud-based platform which we will extend to Basel 3.1 returns that:

- Performs data quality and consistency controls over the regulatory returns.
- Produces automated comparisons on a cell-by-cell basis to accelerate variance analysis processes.
- Generates dynamic visualisation of key data points.




**Basel 3.1 controller's dashboard:**

An automated solution supporting firms' management in visualising the operation of their end-to-end reporting framework. The tool can be leveraged to present the impact of the introduction of Basel 3.1 on a firm's regulatory ratios, as we all as providing an overview of the operation of key controls.

## Access our thought leadership and Hot Topic library

PwC publishes a series of thought leadership papers providing insight into the key implications of credit risk regulatory changes for firms to consider. The full range of these papers can be found at the below link:

https://www.pwc.co.uk/services/risk/risk-modelling/services/making-irb-work-for-you.html

**Examples of thought leadership:**

- Basel 3.1 UK Consultation: PRA aligns closely with global standards
- EBA publishes principles for credit risk modelling data impacted by COVID-19
- PRA proposes principles to manage model risk
- EBA Consultation Paper on IRB Validation - Focus Paper

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# Thank you

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