Financial Services Regulatory Insights

Basel 3.1: Clarity for trading activity as UK finalises rules

HOT TOPIC

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Highlights

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Summary of the Policy Statement

On 12 December 2023, the Prudential Regulation Authority (PRA) published Policy Statement PS17/23 on its approach to the implementation of the Basel Committee on Banking Supervision (BCBS) reforms. The objective of the Basel 3.1 reforms is to reduce unwarranted variability in risk weighted assets (RWAs) by reducing the use of internal models and improving the risk sensitivity of standardised approaches. The policy statement covers the final rules for market risk, credit valuation adjustment risk and operational risk. The implementation deadline is 1 July 2025 with a 4.5 year transitional which ends in January 2030.

The UK's approach largely aligns with the Basel standards (with less divergence than the EU). The PRA has responded to industry feedback on a few specific items but overall the final rules are broadly aligned with CP16/22 - Implementation of the Basel 3.1 standards.

The PRA's latest estimate of the impact of the Basel 3.1 standards for major UK firms is a 3.2% increase in Tier 1 capital requirements by 1 January 2030.

Key highlights

The PRA's proposals for the **Fundamental Review of the Trading Book (FRTB)** are largely consistent with the CP and the BCBS except for two key changes which have been amended following industry feedback.

The PRA has removed the use of the default risk model (DRM) for sovereigns as an exposure class, which will need to be capitalised under the advanced standardised approach (ASA).

The PRA has also provided additional flexibility when mapping real price observations to risk factors where a single price observation is used to derive multiple risk factors for market risk.

The **operational risk** requirements are largely unchanged from the CP, with a couple of amendments for the exclusion of divested activities and the use of estimates when audited numbers are not available.

Most of the **Credit Valuation Adjustment (CVA)** requirements are finalised in line with the consultation. The PRA has confirmed that it will revoke UK CRR CVA exemptions for new trades with pension funds, non-financial counterparties and sovereigns. There are some amendments to the transitional arrangement to remove exemptions for legacy trades. The PRA was not convinced by industry feedback that there would be potential impacts on pricing, access to derivatives, or competitiveness from removing the majority of the CVA exemptions. This confirms a key difference between the UK and the EU regimes.

There are several areas of the Basel 3.1 rules that have yet to be finalised. **In Q2 2024, the PRA intends to publish a second Policy Statement** with the final rules and to provide feedback to responses to the remaining parts of CP16/22. This will include standardised and advanced credit risk, credit risk mitigation, the output floor, Pillar 3 disclosures and regulatory reporting.

The PRA has previously signalled that the credit risk areas where it may "evolve" the requirements include the treatment of unrated corporates, small and medium enterprises, trade finance and accounting provisions.

Fundamental Review of the Trading Book

The PRA's policy statement for the Fundamental Review of the Trading Book (FRTB) aims to improve the coherence and consistency of market risk capital requirements, and ensure these measures are sufficiently sensitive to market moves. The proposal includes a Simplified Standardised Approach (SSA), Advanced Standardised Approach (ASA) and Internal Model Approach (IMA). The UK implementation is largely consistent with the Basel guidelines, Below are the key differences between the PRA's policy statement and its draft rules under the consultation paper CP16/22.

Default risk charge – treatment of sovereign exposures

This was a key point of industry feedback due to the adverse outcome for the sovereign exposure class under the default risk model (DRM), for those firms that wish to adopt the internal model approach (IMA), compared to its standardised counterpart, the default risk charge (DRC). The DRM is subject to a 3 basis point probability of default (PD) floor whilst such exposure classes may be eligible to a 0% default risk weight under the standardised credit risk framework. Under the PRA's revised rules, the default risk weights will align with the standardised credit risk framework.

Sovereigns as an exposure class will still be eligible for other risk measures under the IMA such as the Expected Shortfall (ES) and Non-Modellable Risk Factors (NMRF). It is only the default risk that will be required to be calculated under the ASA.

However, we would also note the following:

- Firms may still be required to capitalise under the Pillar 2 framework sovereigns eligible for a 0% risk weight under the Pillar 1 framework.
- Firms will need to carefully plan their operational implementation to execute the relevant population control required to assign sovereigns to both IMA measures (excluding DRM) and DRC specifically.

Data quality standards for non-modellable risk factors (NMRFs)

In CP16/22, the PRA proposed to permit risk factors to be included in firms' ES models only where those risk factors met minimum quantitative and qualitative criteria, including the ability to map such risk factors to real, observable prices (RPO) so that it can be demonstrated that there is a sufficient number of RPOs to calibrate the ES model accordingly.

In the proposals consulted on, one RPO could only be mapped to one risk factor. There was significant industry feedback on the need to provide more flexibility as more complex instruments may have several risk factors mapped to one RPO (e.g. the value of a risk factor may depend on both the maturity and moneyness of an option).

For that reason, the PRA has agreed to provide further flexibility for the following:

- firms may use one RPO to derive multiple risk factors, subject to quantitative assessments evidence the correlation between the RPO and the risk factor derived from it
- firms will be allowed to choose between regulatory and firm-specific buckets for each dimension of a risk factor for the purpose of the NMRF framework (in this case, each dimension represents a bucket).

Treatment of carbon emissions certificates

The PRA decided to keep the same treatment for carbon emissions certificates, as initially set out in CP16/22. The industry had asked for the introduction of a new bucket for carbon emissions with a preferential risk weight and higher intra-bucket correlation. PRA explained that its rationale is primarily due to the insufficient historical price data for such instruments. However we understand that the PRA may choose to apply future amendments for these exposures as their markets develop and more data is gathered to further calibrate the risk metrics.

Other proposed changes

Some further changes will impact the market risk framework. Such changes are still at the discussion or consultation stage (as applicable) and are expected to enter into the final market risk framework as it comes into force on 1 July 2025. It is critical for firms to assess the impact of such proposed changes and how they will interact with the final FRTB rules, as set out in PS17/23.

We note two key proposed changes which will impact the future of the market risk framework: These are:

- The current consultation on the capitalisation of foreign exchange (FX) positions for market risk, as set out in CP17/23. This primarily relates to the treatment of banking book and structural FX positions.
- The discussion paper on proposed amendments to the hierarchy of methods for determining securitisation capital requirements, as set out in DP3/23. This may impact the default risk charge under FRTB as default risk weight for default risk weights are underpinned that this hierarchy of approaches.

Operational Risk

The PS includes the near final rules on the operational risk framework which will replace all existing approaches for calculating Pillar 1 operational risk capital (ORC) requirements with a single standardised approach (SA) to be used by all firms.

The PRA has made two changes following the consultation. First, firms may exclude divested activities from the scope of the operational risk charge - subject to conditions and supervisory approval. Second, firms may calculate the Business Indicator using business estimates when audited figures are not available.

The PRA has confirmed that it will exercise the national discretion in the Basel framework to set the internal loss multiplier (ILM) equal to 1 to neutralise the impact of historical internal operational risk losses. As a result, firms' operational risk capital requirements would not be directly tied to past losses and instead would be driven more by firm size. Firms must still identify, collect and categorise internal loss data in line with certain requirements:

As outlined in the CP, the PRA will to continue to use supervisory judgement in its approach to calculating Pillar 2A operational risk capital requirements. This includes using loss estimates based on a firm's forecast, historical losses and scenario analysis, and supervisory judgement to inform the setting of a firm's operational risk add-on.

Credit Valuation Adjustment Risk

The PRA's PS is broadly aligned with the consultation - and the Basel framework - which replaces existing approaches with a choice of two primary methods, a standardised approach (SA-CVA) subject to supervisory approval and a basic approach (BA-CVA).

The SA-CVA is underpinned by the use of firm-specific risk sensitivities to counterparty credit spreads and market risk factors and aggregation logic that is consistent with FRTB. This approach treats CVA more like other trading risks, instead of a banking book approach to capture the risk. The PRA has set out more detail on the format and content of the applications for permission to use SA-CVA.

The PRA confirms that it will diverge from BCBS to recalibrate the exposure to pension funds (for both SA-CVA and BA-CVA) to distinguish between the risk profiles of different financial services counterparties (3.5% for IG and 8.5% for non-IG). The PRA will amend the definition of pensions scheme arrangements to include both UK and equivalent third country pension scheme arrangements.

The PRA has confirmed that it will revoke UK CRR CVA exemptions for new trades with pension funds, non-financial counterparties and sovereigns. The PRA was not convinced by industry feedback that there would be potential impacts on pricing, access to derivatives, or competitiveness from removing the majority of the CVA exemptions. This confirms a key difference between the UK and the EU regimes.

Exemptions will also be removed for legacy derivative trades but this will be subject to a five-year transitional arrangement. Following industry feedback the PRA has allowed for a second approach to applying the transitionals to address operational challenges.

PRA will retain the existing UK CRR exemption for client clearing transactions; and will implement an amended approach to cross-border intragroup transactions which does not require EMIR equivalence assessments and relies on similar tests to other intragroup treatments in the capital framework. The intragroup transaction exemption may include certain overseas group entities, subject to conditions.

The alternative approach (AA-CVA) for small, non-complex institutions is broadly unchanged from the proposals.

Counterparty Credit Risk

The PRA confirms that it will recalibrate the Standardised Approach to Counterparty Credit Risk (SA-CCR) by reducing the alpha factor from 1.4 to 1 for new derivative trades with non-financials and pension funds. This is similar to the US approach for commercial end users and reflects a widely held view that SA-CCR is too conservative relative to the Internal Model Method. To allow for portfolio and netting benefits when calculating SA-CCR, firms may apply the lower alpha factor to legacy trades subject to a five year transitional arrangement where the capital reduction for the legacy trades is added back.

The SA-CCR alpha factor reduction will not apply in the leverage ratio framework.

Review of the Pillar 2 Framework

To address concerns about potentially double counting risks between Pillar 1 and Pillar 2, the PRA plans to conduct an off-cycle review of firm-specific Pillar 2 capital requirements ahead of the implementation date. This may result in adjustments to firms' Pillar 2 capital requirements to reflect changes to Pillar 1 RWAs or rebasing firms' variable Pillar 2A requirements. The PRA also plans to rebase firms' PRA buffer based on projected Basel 3.1 RWAs. The PRA will publish further information in due course, including plans to conduct a data collection exercise to inform the off-cycle review.

PRA intends to conduct a broader review of Pillar 2A methodologies after finalisation of the PRA rules to implement the Basel 3.1 standards.

Small Domestic Deposit Takers (SDDT)

The PRA proposals on the interim capital regime for small and domestic deposit takers, formerly “strong and simple” firms, remain broadly unchanged. The PRA intends to consult on a simplified capital framework for SDDTs in Q2 2024.

Impact of the proposals

The PRA's latest estimate of the impact of the Basel 3.1 standards for major UK firms is a 3.2% increase in Tier 1 capital requirements at the end of the transitional period on 1 January 2030. This is based on the 2022 consultation and not the latest changes in the policy statement.

The European Banking Authority (EBA) has estimated the latest EU proposals would increase Tier 1 minimum capital requirements for EU firms by 9.9%. US regulatory agencies estimate their proposals published in July 2023 would increase Common Equity Tier 1 (CET1) requirements for large US holding companies by 16% and 9% for depository institutions at the end of the transitional period.

The headline impacts do not tell the full picture as the impact varies from firm to firm and depends on business model, portfolio and use of internal models. Firms need to assess the impact at a product and business line level to understand the impact of profitability and returns on RWA.

What does this mean for firms?

Day 1 Compliance

With the first policy statement published, firms should take stock of their progress towards implementation and take the necessary steps to achieve compliance on Day 1. The use of the section 166 regime to review the implementation of rules means firms should aim to achieve a high level of compliance from Day 1. Firms should therefore plan sufficient time for parallel runs, obtaining relevant permissions and testing to produce complete and accurate returns. Firms that have not commenced programmes to implement the changes may encounter challenges in meeting the regulatory timelines.

Internal Model Approach for Market Risk

There are several aspects of the policy statement which will impact the cost-benefit analysis of using the internal model approach (IMA) for market risk. For example, whilst the exclusion of sovereign exposures from the DRM will lead to a more beneficial outcome, it will be operationally challenging to implement the relevant bifurcation and population control across both IMA and ASA.

These is a significant divergence in the implementation of the default risk component of FRTB across jurisdictions, which may be an impediment to an IMA permission for some third-country firms. In particular, we note:

- under the proposed US draft rules, default risk model has been revoked and the standardised DRC applies irrespective of where positions are eligible for IMA or not
- the EU is proposing to implement the default risk model in full, with no exemption for sovereign exposures (unlike the PRA).

This divergence between jurisdictions will add further complexity for global firms which may wish to apply IMA across several jurisdictions.

Data collection for off-cycle review of firm-specific capital requirements

The PRA will conduct a data collection exercise to inform the off-cycle Pillar 2 review. Firms should prepare for the request by analysing potential areas of duplication and aim to submit high quality data to inform the recalibration of Pillar 2 buffers.

Eligibility for Interim Capital Regime (ICR)

To be eligible for ICR, the firm must meet the SDDT criteria and provide modification by consent. Firms aiming to access ICR should re-confirm they continue to meet the SDDT criteria. SDDT firms do not have to apply Basel 3.1 and can continue applying existing CRR provisions. ICR would be in place for the period from the implementation date of the Basel 3.1 standards to the implementation date of the SDDT capital rules. Firms will be able to compare the Phase 2 proposals with the Basel 3.1 standards when deciding whether to take up the ICR modification by consent.

Changes to governance, processes, systems and controls

While the near-final policy statements are broadly aligned with the consultation paper, all firms should continue to assess the impact on their current governance, processes, systems and controls across all risk types. Internationally active banking groups are likely to face operational challenges to implement the rules where there are notable divergences across jurisdictions.

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- We have a large team of prudential regulatory experts with an extensive track record of successfully supporting firms to implement complex regulatory change programmes across banks and investment firms.
- We have developed prudential technology tools that can accelerate the implementation of your regulatory change, assessment of your calculations, and the validation of your existing and new reporting forms.
- We have risk modelling experts who can help with model development, validation and testing to meet the regulatory requirements.
- We have extensive experience of assessing firms' interpretations and judgements against regulatory expectations and peer group practices which helps our clients navigate a complex regulatory landscape.

If you have any questions on this policy statement, what is means for you, and how we may be able to help you, please reach out to the contacts listed on the left and we're happy to set up a discussion.

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