CP16/22 – Implementation of the Basel 3.1 standards

Consultation Paper 16/22

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Content

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Reponses are requested by Friday 31 March 2023.

The PRA prefers all responses to be sent by email to: CP16_22@bankofengland.co.uk.

Alternatively, please address any comments or enquiries to:

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Overview

1.1 The global financial crisis revealed significant shortcomings in the calculation of risk-weighted assets[1] (RWAs) and capital ratios, defined as the ratio of capital held by firms to RWAs. The Basel Committee on Banking Supervision (BCBS) identified three factors as key to mitigating the severity of subsequent financial crises:

- raising the quantity of capital in the financial system, per unit of risk;
- increasing the quality of capital held by firms; and
- improving the accuracy of risk measurement by firms.

1.2 In response, the BCBS agreed a series of reforms to its **standards** (Basel standards). These reforms, collectively known as the **'Basel III standards'**, were intended to enhance the resilience of banks throughout the economic cycle. The Prudential Regulation Authority (PRA) was actively involved in their development and in the negotiations that led to their agreement as a package.

1.3 Many of the Basel III standards have already been implemented in the UK through EU legislation that was onshored as part of the UK's exit from the EU[2] on 31 December 2020, and subsequent work by the PRA, including through new rules and policy material relating to the **'Implementation of Basel standards: Final rules'** in Policy Statement (PS) 22/21 and '**The UK leverage ratio framework'** in PS21/21.

1.4 The phases of the Basel III standards that have already been implemented primarily focused on increasing the quantity and quality of capital maintained by firms (the numerator of capital ratios) and also introduced new requirements for leverage and liquidity.

1.5 This Consultation Paper (CP) covers the parts of the Basel III standards that remain to be implemented in the UK.[3] The PRA refers to them as the 'Basel 3.1 standards'. The proposals address mainly the last element of the reforms – the measurement of RWAs (the denominator of capital ratios). The proposals would, among other things, revise the calculation of RWAs by improving both the measurement of risk in internal models (IMs) and standardised approaches (SAs), and the comparability of risk measurement across firms.

1.6 Across the overall package of proposals set out in this CP, the PRA has aligned with the Basel 3.1 standards, while exercising its judgement to tailor them where it is appropriate and the evidence is supportive. The package advances the PRA's primary objective to promote the safety and soundness of the firms that it regulates and its secondary objective to facilitate effective competition, as well as considering the various matters to which it must ‘have regard’, as explained in more detail below.

Purpose of this consultation

1.7 This CP sets out the PRA’s proposed rules and expectations with respect to the implementation of the Basel 3.1 standards, and consists of the following:

- a revised SA for credit risk;
- revisions to the internal ratings based (IRB) approach for credit risk;
- revisions to the use of credit risk mitigation (CRM) techniques;
- removal of the use of IMs for calculating operational risk capital requirements,[4] and a new SA to replace existing approaches;
- a revised approach to market risk;[5]
- the removal of the use of IMs for credit valuation adjustment (CVA) risk, replaced by new standardised and basic approaches; and
- the introduction of an aggregate ‘output floor’ to ensure total RWAs for firms using IMs and subject to the floor cannot fall below 72.5% of RWAs derived under SAs, to be phased in over five years.

1.8 The proposals also revise certain areas of the Basel III standards already implemented in the UK and would have consequential impacts on the UK implementation of the leverage ratio, and elements of the liquidity and large exposures frameworks. These consequential impacts are described in paragraphs 1.57 to 1.59 below.

Scope

1.9 This consultation is relevant to PRA-authorised banks, building societies, PRA-designated investment firms, and PRA-approved or PRA-designated financial or mixed financial holding companies (collectively ‘firms’).

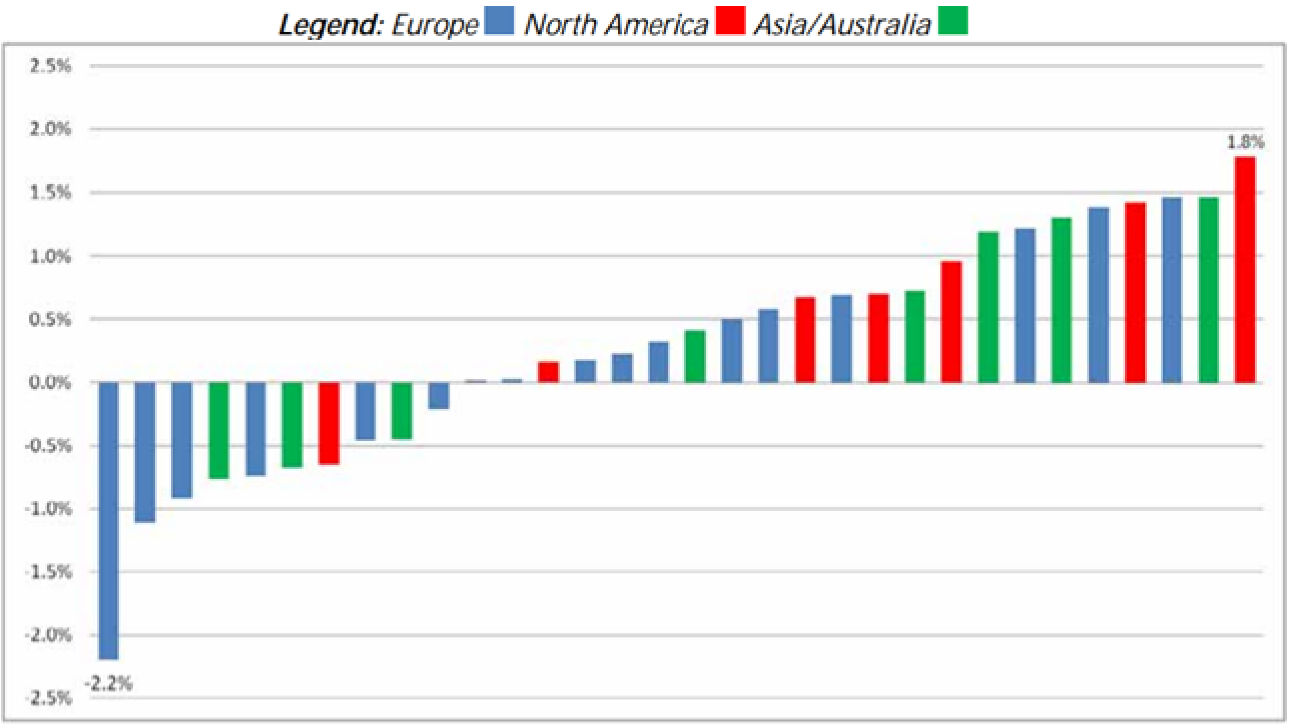
1.10 PRA-authorised banks, building societies and designated investment firms that meet the ‘Simpler-regime criteria’ definition, as specified in paragraph 1.53 below, Chapter 2 – Scope and levels of application, and Appendix 9, would not have to apply the proposed implementation of the Basel 3.1 standards set out in this CP, but could choose to be subject to them. However, the proposals should still be of interest to all firms meeting these criteria, for the reasons set out in paragraphs 1.53 to 1.56 below. The PRA invites responses from such firms on the proposals set out in this CP, including how aspects could be adjusted for future application to them.

Background and overview of proposals

1.11 The global financial crisis revealed significant shortcomings in the pre-crisis regulatory framework, particularly with respect to the calculation of risk-weighted capital ratios. Investors lost confidence in capital ratios that were calculated in accordance with earlier iterations of the Basel standards, known as Basel I and Basel II.

1.12 In December 2017, the BCBS also noted that its own empirical analysis showed a **'worrying degree of variability'** in the calculation of risk weights at the peak of the crisis. Importantly, variability in RWAs also makes firms' capital ratios less consistent and comparable. While some variability is to be expected in RWAs calculated using IMs, a high degree of variability undermines confidence in capital ratios, and; therefore, confidence in the resilience of firms. Chart 1 shows the **BCBS's July 2013 analysis of risk weight variation on firms' capital ratios**. It shows the results of a portfolio benchmarking exercise (a hypothetical portfolio exercise (HPE)), under which 32 large internationally active banking groups were asked to 'evaluate the risk of a common set of (largely low-default) wholesale obligors and exposures'.[6] The HPE revealed 'notable dispersion in the estimates of PD and LGD assigned to the same exposures'. Similar HPEs focused on market risk in the trading book found similarly high levels of variation.

Chart 1: Impact of Risk Weight variation on capital ratios



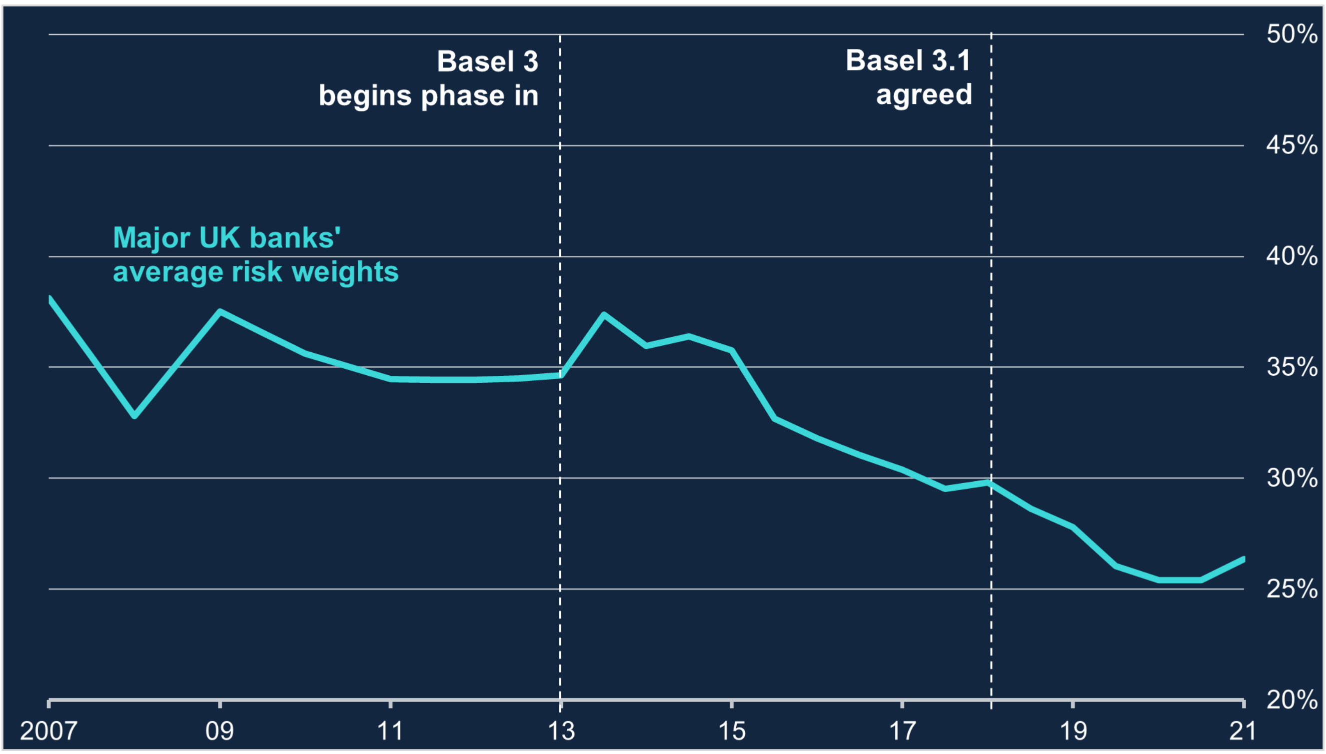
Source: BIS RCAP – Analysis of risk-weighted assets for credit risk in the banking book. Notes: Change from 10% capital ratio if individual bank risk weights from the HPE are adjusted to the median from the sample. Each bar represents one bank. The chart is based on the assumption that variations observed at each bank for the hypothetical portfolios are representative for the entire sovereign, bank, and corporate portfolios of the bank are adjusted accordingly. No other adjustments are made to RWA or capital.

1.13 As demonstrated in the global financial crisis, if a lack of confidence in risk-weighted capital ratios increased in a downturn and put in doubt the adequacy of capital levels in firms, it could have implications for the resilience of the financial system as a whole. As a consequence, the financial system may not be able to continue lending to households and businesses during a downturn, which would amplify, rather than absorb, economic shocks.

1.14 The Basel 3.1 standards have been developed by the BCBS to address these concerns and aim to restore credibility in risk-weighted ratios, through greater robustness and risk-sensitivity in the SAs and constraints on the use of IMs, and restricting the RWA benefits that IMs can provide. These goals link closely to the PRA's primary objective.

1.15 In the UK, there has been a downwards drift in average risk weights (measured as the ratio of RWA to assets) for major UK banks in the last decade (Chart 2). Average risk weights fell from 37% in 2015, at the time of the negotiations of the Basel 3.1 standards, to historically low levels of 25% in 2020. That trend could reflect a number of factors, including firms shifting to less risky assets and historically low levels of losses, but it could also reflect, in part, under-estimation of internally modelled risks due for example to model risk and data uncertainties. This highlights the importance of ensuring risk measurement remains robust to underpin confidence in capital ratios and the quantum of capital set against risks.

Chart 2: Major UK banks'[7] aggregate risk weights have fallen over time



Source: Firms' published accounts and related public disclosures, PRA regulatory returns, PRA analysis and calculations.

1.16 The proposals set out in this CP aim to address the concerns described above by improving risk measurement and making the calculation of RWAs more robust and consistent across firms through proposing:

- a revised set of SAs across all risk areas to introduce more granular requirements that better reflect the risk of firms' exposures and make them a more credible alternative to using IMs; and
- changes to the IM approaches available to firms. For example, in some areas (CVA risk and operational risk), the proposals would remove IM approaches entirely in order to address concerns that the models could not effectively measure these risks and added unnecessary complexity. With respect to IRB, for exposures where IRB approaches remain available, the proposals would reduce the available flexibility in modelling approaches and introduce greater constraint on some model inputs. The most significant changes to the IM approaches are in the market risk framework, where the PRA proposes to introduce a new, more comprehensive modelling approach, alongside improvements to the robustness of the trading book/non-trading book boundary.[8]

1.17 Finally, the proposed new output floor aims to provide a backstop that limits the extent to which firms using the IM approaches (IM firms) can lower their RWAs relative to the revised SAs used by SA firms. This floors IM firm RWAs at 72.5% of their SA RWAs on average across all exposures. The PRA proposes that IM firms apply the same revised SAs in the output floor calculation to those used by SA firms. This is intended to ensure that the output floor is a consistent and transparent backstop to modelled risk weights. It would also help enhance comparability and facilitate more effective competition between SA and IM firms.

Accountability framework

1.18 In carrying out its policy-making functions, the PRA is required to comply with several legal obligations. The PRA has a statutory duty to consult when introducing new rules (FSMA s138J), or new standards instruments (FSMA s138S). When not making rules, the PRA has a public law duty to consult widely where it would be fair to do so.

1.19 The proposals set out in this CP have been developed by the PRA in accordance with its statutory objectives and informed by the regulatory principles and the matters to which it must have regard in making policy as set out in the Financial Services and Markets Act 2000 (FSMA). Appendix 6 lists the statutory obligations applicable to the PRA's policy development process. Where the rules proposed are Capital Requirements Regulation (CRR) rules, the analysis in this CP sets out how the matters to which it must have regard when making CRR rules have affected the proposals.

1.20 The Financial Services Act 2021 (FS Act) enables the implementation of the proposals set out in this CP in the UK by providing HM Treasury (HMT) with a power to revoke provisions from the CRR.[9] HMT is proposing to use this power to revoke parts of the CRR so that the PRA can make the rules proposed in this CP.[10]

1.21 However, some of the CRR provisions would remain in UK primary legislation. Firms should read this CP together with the provisions that have already been transferred to the PRA Rulebook under earlier phases of the implementation of the Basel III standards, including through new rules and policy material relating to the 'Implementation of Basel standards: Final rules' in PS22/21, 'The UK leverage ratio framework' in PS21/21 and those that would remain in the CRR to fully understand the proposals.

PRA objectives analysis

1.22 The proposals set out in this CP would advance the PRA's primary objective to promote the safety and soundness of the firms that it regulates. Improving the measurement of risk would help ensure firms are adequately capitalised given the risks to which they are exposed. Moreover, the proposals address weaknesses in the current Pillar 1 framework in a direct, consistent, and transparent way. It is important to underpin confidence in the measure of risk and the quantum of capital set against that risk. In turn, these would deliver the primary benefit of the Basel III package in lowering the likelihood of future financial crises. In particular, the proposals would advance the PRA's primary objective by:

- simplifying and reducing the range of approaches available for RWA calculations, thereby promoting the consistent application of approaches across firms through simpler and clearer requirements;
- improving the risk-sensitivity of SAs in the capital framework, resulting in RWAs that are more reflective of risk for firms using those approaches;
- constraining the use of IM approaches in areas where RWAs cannot be modelled in a robust and prudent manner, to reduce unwarranted RWA variability; and
- introducing an output floor, limiting how low internally-modelled RWAs can fall below those produced under the revised SAs, thus reducing excessive variability and cyclicality in RWAs.

1.23 The proposals would also advance the PRA's secondary objective to facilitate effective competition. In particular, they would:

- increase risk-sensitivity under the SAs which aims to ensure firms using the SAs calculate RWAs that are better aligned to the risk of their portfolio and to those calculated by IM firms;

- require more robust and prudent modelling within IM approaches, and limit the reduction in RWAs that can be achieved through their use, thereby reducing the potential competitive advantage that IM firms currently have over SA firms;
- promote a more consistent and level playing field, by basing the proposed output floor on the same SA calculation for both SA and IM firms; and
- reduce barriers to entry for SA firms to use IM approaches, for example by permitting the roll-out of the IRB approach by individual asset classes rather than across all credit risk exposures, which would improve opportunities for existing SA firms to use IM approaches.

1.24 The chapters of this CP set out in more detail how the particular proposals advance the PRA's primary and secondary objectives.

'Have regards' analysis

1.25 In developing the proposals set out in this CP, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent in April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules.

1.26 Across all the proposals set out in this CP as a whole, the 'have regard' factors that the PRA considered to be the most significant in its analysis were **relevant international standards (FSMA CRR rules)** and **the relative standing of the UK as a place for internationally active firms to operate (FSMA CRR rules)**.

1.27 In considering these have regards and the specific characteristics of the UK's financial system, the PRA has identified a number of areas where, due to the flexibility afforded by the UK's withdrawal from the EU, limited adjustments to international standards could better capture risk and further support the competitiveness and the relative standing of the UK, while advancing the safety and soundness of firms and contributing to strengthening UK financial stability. For example, the PRA proposes to apply targeted measures to address concerns with respect to risk-weighting of exposures to unrated corporates under the credit risk SA and the calibration of the standardised approach to counterparty credit risk (SA-CCR). The relevant considerations for these adjustments are described in more detail in the relevant chapters of this CP. In developing the proposals, including the proposed adjustments to international standards, the PRA has had regard to the proposals that certain other major jurisdictions have made.[11]

1.28 While the PRA is proposing limited adjustments to international standards, it considers that, overall, the proposals set out in this CP adhere to international standards, which in turn supports the relative standing of the UK. As identified by the **European Banking Authority**

(EBA) and European Central Bank (ECB), the European Commission's proposals include a number of deviations from international standards.[12] If adopted, these deviations would likely make the EU an international outlier, particularly in its approach to the implementation of the output floor. The PRA's analysis of other jurisdictions' proposals suggests that the vast majority are also proposing to adhere to international standards, including for example Singapore, Hong Kong, Switzerland, Canada, and Australia.

1.29 International standards support an open, efficient, and resilient global financial system. In doing so, they reduce competitive distortions across countries, enabling firms to compete on a global level playing field. The UK, as a global financial centre, is a particularly important part of a deeply interconnected global financial system. The International Monetary Fund has described **UK financial stability as a global public good**. However, this also means that the risks that the UK faces often emerge beyond its borders. Because of the interconnected nature of the global financial system and the potential for financial distress to spread across borders, the PRA's objectives are most effectively advanced through alignment with international standards.

1.30 The PRA considers that there is a clear link between alignment with international standards and the relative standing of the UK. Adherence to international standards underpins the UK's position as one of the largest global financial centres as, in the PRA's view:

- financial services firms and other stakeholders rely on internationally aligned standards being implemented, and the resulting stability and predictability, when they choose to conduct their business in the UK;
- it is more efficient for firms to operate across jurisdictions that adopt and apply international standards in a predictable and stable way as they do not need to follow a different regime in each jurisdiction where they operate;
- regulators in other jurisdictions allow such deep interconnections with the UK financial system because of the assurance provided by UK authorities' implementation of robust standards; and
- the UK's position as a global financial centre also relies on it being open for firms from around the globe to conduct business. The financial sector, which generated 8.3% of the UK GDP in 2020 and represents the third largest proportion of the economy among OECD nations,[13] is large and open. To protect the UK economy from global shocks, it is particularly important to adhere to robust standards.

1.31 A vibrant financial sector in turn underpins core economic activities in the UK and supports a healthy and growing domestic economy. Consumers and businesses can borrow, invest, and manage risk with confidence that individual institutions within it are sufficiently robust to withstand economic shocks and can; therefore, maintain their lending.

1.32 Other 'have regards' that gave rise to particularly significant issues for consideration in individual proposals are set out in the chapters of this CP.[14] In its analysis of the proposals set out in this CP as a whole, the PRA considered the following other 'have regards' to be the most significant:

1. Efficient and economic use of PRA resources (FSMA regulatory principles):

- The PRA has considered whether the proposals would result in efficient and economic use of the PRA's resources. To gain assurance on the successful implementation of these changes, supervisors would need to monitor firms' initial implementation and ongoing application. Although some proposals would increase upfront resourcing demands to review firms' IM submissions and applications to use certain approaches, others remove modelling altogether and reduce modelling choices, which should reduce supervisory resource requirements over time.
- The proposals also aim to limit resource costs by restricting approval processes in some areas, such as CVA, to only the most advanced approach available to firms. Overall, the PRA considers that the prudential benefits of the proposals outweigh the additional resource costs.

2. Proportionality of the PRA's regulation (FSMA regulatory principles):

- The PRA has considered whether the proposals strike an appropriate balance between the expected prudential benefits gained from their implementation and the burden and restrictions imposed on any firm.
- The PRA considers that the proposals are proportionate. They would introduce a more risk-sensitive capital framework in which the regulatory burden of calculating capital requirements is proportionate with the risks faced by a firm, with simpler alternatives available for firms with lower risk profiles, such as the proposals for market risk and CVA.
- Additionally, firms meeting the proposed Simpler-regime criteria would not have to apply the proposed implementation of the Basel 3.1 standards, but could choose to be subject to it, as set out in paragraph 1.54 below and Chapter 2. This would allow the PRA to separately consider, including through responses to this CP from small firms, the appropriate risk-based capital framework for these firms, as well as ensure that small firms only experience one change to the applicable risk-based capital framework.

3. Provision of finance to UK businesses and consumers on a sustainable basis (FSMA CRR rules), sustainable growth (FSMA regulatory principles), and growth (HMT recommendation letters):

- The PRA considers that the proposals would help to ensure that firms are appropriately capitalised for the risks that they face. This would enable firms to continue providing finance for the real economy throughout the economic cycle, rather than having to reduce lending in stress, and exacerbate the economic cycle.

- Where the PRA considers risk-based adjustments to the Basel 3.1 standards are appropriate and would support the provision of finance, the proposals do so. For example, with respect to unrated corporates risk-weighted under the SA for credit risk, the PRA proposes to adjust the Basel 3.1 standards by introducing the option to risk-weight investment grade unrated corporates at a lower weight than prescribed in the Basel 3.1 standards at 65%, and non-investment grade unrated corporates at a higher rate of 135%.
- The PRA is seeking further evidence through this consultation regarding the appropriate calibration of this adjusted approach, particularly for non-investment grade unrated corporates.
- Another example is with respect to derivatives. The PRA proposes to adjust the calibration of CVA and SA-CCR where the PRA considers the impact to be overly conservative. This 'have regard' was also factored into the PRA's considerations when developing its proposals related to the treatment of exposures to small and medium-sized enterprises (SMEs) and infrastructure projects in the credit risk framework. The PRA welcomes feedback, both quantitative or qualitative, on its proposed approach and calibration of the risk weights for these exposures, and it would encourage respondents to provide relevant evidence.

4. 2050 net-zero target in the Climate Change Act 2008 (FSMA regulatory principles introduced by the FS Act and the HMT recommendation letters):

- The Basel 3.1 standards were not designed to include specific climate risk-related measures. Therefore, the proposals set out in this CP are broadly neutral in terms of the UK net-zero target. Nevertheless, the net-zero target gave rise to some issues in the development of a number of proposals. Examples include:
  - for specialised lending under the IRB approach, were the PRA to require the 'slotting' approach for object and project finance exposures, there could be an increase in risk weights, and firms could be deterred from investing in green finance projects. The PRA's proposal instead is to continue allowing the use of the foundation internal ratings based (FIRB) and advanced internal ratings based (AIRB) approaches, or slotting for object and project finance exposures, which should avoid any potential negative impact there might otherwise have been on the net-zero target;
  - for specialised lending in the credit risk SA, the PRA considers that the proposed removal of the infrastructure support factor would be offset by the PRA's proposal for project finance exposures (which explicitly covers environmental infrastructure projects) where 'high quality' exposures would receive lower risk weights; and
  - for market risk, the PRA proposes to specify a unique risk weight for carbon emissions certificates, which could be adjusted if the PRA sees future evidence that the calibration

of the Basel 3.1 standards is excessively conservative.

- In parallel to its policy development work on the proposals set out in this CP, the PRA has a significant programme of domestic policy and supervision work related to climate risk and is actively engaging in international policy development at the BCBS. The Bank of England's (the Bank) **2021 Climate Change Adaptation Report** presented initial analysis of potential policy options that could be developed. Following that report, on Wednesday 19 October and Thursday 20 October 2022, the Bank and PRA hosted a climate and capital conference to help advance work in this area. The PRA will provide an update on its approach to this issue in due course.

5. Different business models (FSMA regulatory principles):

- The PRA considers that the proposals set out in this CP help to ensure that firms are adequately capitalised for the risks that they take. The proposed changes to the use of IMs and greater risk-sensitivity proposed in the SAs would have different impacts on firms, depending on their business mix and risk profile, which the PRA considers to be consistent with the objectives of the Basel 3.1 standards.
- This have regard was most relevant to the PRA's considerations for various issues in credit risk SA (such as the approach for real estate, regulatory retail, and unrated corporate exposures), the proposals to allow multiple approaches for market risk and CVA, and with respect to the application of the output floor to mutuals (see next paragraph).

1.33 In addition, the PRA has a statutory obligation to give an opinion on the impact of its proposals on **mutual societies (s138K FSMA)**, hereafter 'mutuals', which refers to building societies, friendly societies, co-operatives, and community benefit societies.[15] For the purpose of this CP, all references to 'mutuals' refer to building societies, which are the only group of mutuals within the proposed scope of application as set out in Chapter 2.[16] The PRA considers that mutuals as a group would not be impacted differently to other types of firms, particularly since most use SAs. With respect to mutuals that use IM approaches, the PRA considers that these firms may experience a relatively higher impact from the output floor, where IRB approaches continue to produce lower average risk weights for residential retail mortgages relative to the SA, following the implementation of changes to Supervisory Statement (SS) 11/13 – **'Internal Ratings Based (IRB) approaches'** as set out in PS13/17 – **'Residential mortgage risk weights'**, PS11/20 – **'Credit risk: Probability of Default and Loss Given Default estimation'**, and the implementation of the Basel 3.1 standards as proposed in this CP. This is because the business models of many mutuals are relatively undiversified.

1.34 The PRA has considered this impact and concluded that a prudential case nonetheless exists to apply the output floor to mutuals with IM permissions, in line with the proposed approach to other IM firms and ring-fenced bodies (RFBs). While mutuals may be more impacted by the proposed output floor due to operating with legal constraints on their capacity to diversify, this does not reduce their exposure to model risk, which may in fact be amplified by credit risk concentration, and less diversified use of models.

1.35 The PRA considers that the impact of the output floor on mutuals using IM approaches may also be smaller when considered alongside the combined impact of other elements of the capital framework, for example firm-specific buffers (see Chapter 10 – Interactions with the PRA's Pillar 2 framework). From the perspective of competition, the PRA also considers that the proposed approach would result in these mutuals being treated consistently with RFBs, which are similarly concentrated in residential retail mortgage lending.

1.36 However, in recognition of the constraints on the business models of mutuals and the potential impact due to their concentration in residential retail mortgage lending, the PRA particularly welcomes responses from mutuals using IM approaches on the impact of the output floor proposed in this CP. The PRA would additionally welcome any responses that could be useful as the PRA develops its strong and simple regime.

1.37 The PRA has considered its obligation to have 'due regard' to the need to promote equality of opportunity, eliminate discrimination and foster good relations between those with protected characteristics and others set out in the Equality Act 2010 in the context of the proposals set out in this CP, and has not identified any adverse impacts.

Cost benefit analysis

1.38 In developing the proposals set out in this CP, the PRA has considered a range of factors that contribute to the cost benefit analysis (CBA) underpinning the proposals.[17] The PRA has assessed the costs and benefits of individual policies 'bottom up' (as set out in each policy chapter) and considered the aggregate impact 'top down'. The CBA is forward-looking and; therefore, based on uncertainties and assumptions.

1.39 As described above, after the global financial crisis, the BCBS identified three key factors from the global financial crisis to be addressed with reforms to banking prudential policy. These factors were:

- more capital in the system relative to the underlying risks;
- better quality capital in terms of loss absorption; and
- more accurate risk capture and measurement.

1.40 Accurate and appropriate risk measurement and capture are the foundations that ensure that the benefits of more, and better quality, capital are able to be realised in the future. The mismeasurement of risk has significant implications for the UK economy. Underestimation of risk reduces the overall level of capital in the system for a given level of risk, increasing the likelihood of a financial crisis, misallocation of financing, and substantial losses to the UK economy. Overly conservative estimation of risk, while still realising the benefits of reducing the likelihood of financial crises, unduly raises costs, misallocates financing, and reduces the deposit-taking sectors' ability to support the wider economy.

1.41 When implementing the Basel III standards, the PRA presented research that showed[18] that increasing the amount and quality of capital in the UK financial system directly reduced the likelihood of a future financial crisis, which has significant permanent positive effects on UK economic growth, even once costs to firms are taken into account. The benefits to the UK economy are the losses to UK GDP that are avoided as future financial crises become less frequent. Importantly, these benefits are realised only if risks are appropriately identified and captured within the regulatory framework.

1.42 The proposals set out in this CP provide a more stable, internationally-consistent basis for addressing key issues with respect to the mismeasurement of risk by improving IM approaches, making the SAs more risk-sensitive, and limiting excessive variability and cyclicality in RWAs. All of these improve measurement of risk within Pillar 1.

1.43 The PRA has in the past used existing regulation, at least partly, to address potential mismeasurement of risk by firms. This includes adjustments to individual firm requirements under Pillar 2A and the PRA (stress testing) buffers. The proposals set out in this CP would deal more comprehensively and directly with measurement issues and, in particular:

- revise IM approaches to credit risk and introduce an output floor to address model risk, which raises non-stressed RWAs for some firms and more comprehensively captures risks measured under Pillar 1. In turn, all else being equal, the size of the PRA buffer for some firms may be reduced;
- amend the Pillar 1 treatment of market risk and operational risk in line with new international standards. To the extent these changes improve risk-capture in Pillar 1, Pillar 2A requirements which cover risks not adequately addressed by Pillar 1 would be adjusted accordingly;
- limit the extent to which firms can use the IM approaches, given evidence of excessive variability in RWA calculations; and
- improve transparency via Pillar 3 disclosures of these risks and improve market discipline of firms' risk considerations.

1.44 Implementation of the Basel 3.1 standards as proposed would, therefore, help to ensure that the UK is able to continue to realise the benefits of the post global financial crisis reform package, including having more, and better quality, capital in the UK banking system. If the proposals set out in this CP are not implemented, risks may not be adequately measured, particularly within Pillar 1. This outcome would reduce the safety and soundness of firms and raise the probability of crises in ways that would be difficult to detect, particularly if measures of risks within SAs and complex IMs diverge over time. The proposals set out in this CP would also help maintain trust and confidence among stakeholders (including international investors and regulators) in the UK financial system which is host to one of the largest global financial centres.

1.45 The PRA's proposed implementation of the Basel 3.1 standards also advances the PRA's secondary objective of facilitating effective competition. For some exposures, firms that use IMs can typically apply lower capital requirements than firms that use SAs, given the higher risk-sensitivity of IM approaches compared to the SAs. Improvements to the risk-sensitivity of SAs, more robust and prudent modelling requirements for use of IMs, and the application of the output floor would limit the extent to which measurement of RWAs would diverge between IM and SA firms.

1.46 In total, the benefits of the proposals set out in this CP would primarily be driven by improvements to the safety and soundness of firms. Additional benefits would be derived from more effective competition among firms, and the maintenance of trust and confidence in the UK as a global financial centre which, in turn, would support the international competitiveness of the UK.

1.47 Set against the benefits, there would be costs arising from the implementation of the Basel 3.1 standards, as the PRA updates its supervisory approach and as firms make necessary adjustments to their risk measurement approaches.

1.48 For affected firms, there would be compliance costs of implementing the Basel 3.1 standards. These compliance costs would fall most significantly on large banks and large building societies that have the most complex business models and are most able to absorb these costs.

1.49 There would also be some relatively small costs to affected firms overall, associated with the need to adjust capital resources in response to the proposals, although the impact would differ for different firms. For example, based on an analysis of past firm behaviour and quantitative impact study (QIS) data provided by firms, there would be an overall decrease in capital requirements for smaller-sized building societies, while large banks would overall see a small increase.

1.50 The QIS data provides a rough starting point for estimating the total impact that the proposals set out in this CP would have on RWAs, but it would be a significant over-estimation. Where measured RWAs increase, Pillar 1 requirements would rise. The PRA would expect measured capital ratios to fall as a result. The PRA does not; however, intend to require firms to capitalise for the same risk twice. This means that where the impact of poorly measured risk weights was previously captured by the PRA in Pillar 2A requirements or the PRA buffer, those would fall as Pillar 1 increases. This would mean that both capital ratios and minimum Pillar 2 capital requirements would fall. Moreover, the impact on RWAs at the start of the output floor transition period (which would begin from January 2025, the proposed implementation start date; see paragraph 1.64) is small and only builds slowly over the proposed five-year transitional period. This transitional period would allow firms to find the most efficient, least costly path to full compliance minimising the impact.

1.51 The analysis anticipates that the small overall cost to firms would also have a subsequent very small impact on overall UK economic activity. However, the impact of the costs set out in the analysis is a highly conservative estimate, and the actual impact on firms would likely be smaller than set out in the cost benefit analysis.

1.52 Overall, the costs and benefits of the proposals set out in the CP need to be considered in the context of all regulatory measures taken in response to the global financial crisis. The PRA's implementation of the initial phase of the Basel III standards raised the overall amount and quality of capital relative to total risk in the financial system, the benefits of which are to reduce the likelihood of financial crisis. The implementation of the Basel 3.1 standards is a necessary foundation for these benefits to be realised. The PRA anticipates that benefits to the UK economy of avoiding future financial crises, as well as the additional benefits of improving the competitive landscape for firms in the UK and underpinning international confidence in the UK as a global financial centre, significantly outweigh the costs of implementing all the Basel III standards.

Interaction with other frameworks

Strong and simple

1.53 In Discussion Paper (DP) 1/21 – **'A strong and simple prudential framework for non-systemic banks and building societies'**,[19] the PRA discussed the most appropriate approach to designing a simpler prudential regime for small banks and building societies. The majority of respondents preferred a streamlined approach to designing the prudential requirements under the simpler regime (ie using the existing prudential framework as a starting point and modifying elements that appear to be over complex for smaller firms) to a focused approach (ie adopting a narrower, but more conservatively calibrated set of new prudential requirements).[20] Some respondents to DP1/21 were concerned that a focused regime would create an additional barrier to growth, whereas it would be more straightforward to transition out of the simpler regime under a streamlined approach.

1.54 Firms meeting the proposed Simpler-regime criteria, as set out in Box A in Chapter 2 and Appendix 9 would not have to apply the proposed implementation of the Basel 3.1 standards as set out in this CP. Instead, the PRA proposes that these firms can choose to enter a transitional regime based on current CRR provisions (the 'Transitional Capital

Regime') during the interim period between the proposed implementation date for the Basel 3.1 standards and the future implementation date for a permanent risk-based capital regime for Simpler-regime Firms. However, the PRA proposes that firms that meet the Simpler-regime criteria would be able to choose to be subject to, without delay, the proposed implementation of the Basel 3.1 standards as set out in this CP should they prefer to do so.

1.55 The PRA intends to consider the Pillar 1, Pillar 2, and buffer requirements in the simpler regime in Phase 2 of the strong and simple project.[21] The PRA considers that assessing these different aspects of capital requirements together would support the development of a coherent, simple, and proportionate risk-based capital framework for Simpler-regime Firms.

1.56 In its current analysis, the PRA is considering whether the proposed revised approaches for credit risk SA and CRM, as set out in this CP, would be the appropriate starting point for designing the simpler regime's risk-based capital framework.

Leverage ratio

1.57 Effective as of 1 January 2022, the PRA implemented most of the changes to the calculation of the leverage exposure measure[22] that were made to international standards in the process of finalising Basel 3.1. However, some of the changes to those international standards were not implemented at that time, as they relate to changes to the credit risk SA in the risk-weighted capital framework set out in this CP. The proposed changes to the treatment of off-balance sheet items in Chapter 3 – Credit risk – standardised approach, and the proposed amendment to the SA-CCR set out in Chapter 7 – Credit valuation adjustment and counterparty credit risk would flow through to the leverage framework. The PRA does not propose new policy with respect to the leverage ratio requirement in this CP.

Large exposures

1.58 The large exposure requirements in the CRR have already been transferred to PRA rules and amended to implement the Basel III standards. However, the Basel 3.1-related large exposure standards were not implemented at that time because they depend on changes to the credit risk SA in the risk-weighted capital framework set out in this CP. The PRA is not proposing changes to the large exposure requirement in this CP, although the proposed changes to prudential standards set out in this CP, if implemented, would have a consequential impact on the large exposure requirements. For example, CRM techniques set out in Chapter 5 – Credit risk mitigation for calculating capital requirements would also be used for calculating net large exposures, subject to the broader conditions in the large exposure requirements.

Liquidity risk

1.59 Effective as of 1 January 2022, the PRA implemented the BCBS net stable funding ratio (NSFR) standard in PRA rules, and it transferred the BCBS liquidity coverage ratio (LCR) standard into PRA rules. The Basel 3.1 standards did not make amendments to either liquidity standard. Where relevant, however, the proposed changes to prudential standards set out in this CP would automatically flow through to the LCR and NSFR, including in relation to risk weights for mortgage loans under the credit risk SA.

Structure of the CP

1.60 The implementation of the Basel 3.1 standards would require policy to be made across a number of areas. This CP is structured into the following chapters. The draft rules and related policy material are included in the relevant appendices.

- **Chapter 2 – Scope and levels of application** – This chapter sets out the PRA's proposed scope and levels of application for the proposals set out in this CP, the proposed approach for small firms meeting the proposed Simpler-regime criteria, and an overview of the CRR provisions relating to prudential consolidation.
- **Chapter 3 – Credit risk – standardised approach** – This chapter sets out the PRA's proposals to change the SA requirements and the PRA's expectations in line with the Basel 3.1 standards. The proposed changes include a more risk-sensitive approach to residential mortgage lending, revisions to the risk weights for corporate exposures including to SMEs, the introduction of specific treatments for 'specialised lending' exposures, removal of implicit assumptions of sovereign support for exposures to banks, changes to the risk weights for equity exposures, changes to off-balance sheet conversion factors, and proposed due diligence requirements for use of external credit ratings.
- **Chapter 4 – Credit risk – internal ratings based approach** – This chapter sets out the PRA's proposals to update the IRB approach in line with the Basel 3.1 standards. The proposed changes include restrictions on the use of IRB for equities and low default portfolios, such as exposures to banks and other financial institutions, large corporates, and sovereign exposures. Other proposals include changes to the risk parameters used in IRB modelling, including new input floors for probability of default (PD), loss given default (LGD) and exposure at default (EAD), and greater specification of parameter estimation practices to reduce variability in RWAs for portfolios where the IRB approaches remain available.
- **Chapter 5 – Credit risk mitigation** – This chapter sets out the PRA's proposals to implement the Basel 3.1 standards for CRM, including changes for both funded and unfunded credit protection. It also sets out proposed amendments to the PRA's expectations with respect to CRM. The PRA considers the changes would introduce greater clarity regarding the framework.
- **Chapter 6 – Market risk** – This chapter sets out the PRA's proposals to implement the Basel 3.1 standards for market risk. These comprise the introduction of three new

approaches to replace the current methodologies: the simplified standardised approach (SSA) for firms with small or simple trading activities; the advanced standardised approach (ASA), a risk-sensitive approach for firms without permission to use an IM; and the internal model approach (IMA). The proposals would also retain the existing derogation for small trading book business, which permits firms with very limited trading activity to use the credit risk approach to measure market risk.

- **Chapter 7 – Credit valuation adjustment and counterparty credit risk** – This chapter sets out the PRA's proposals to implement the Basel 3.1 standards for CVA risk. These comprise the introduction of three new approaches for calculating the CVA risk capital requirement: the fall-back alternative approach (AA-CVA); the basic approach (BA-CVA); and the standardised approach (SA-CVA). The new CVA framework and methodologies are proposed to replace the current calculation methodologies. The proposals would also adjust the calibration of the standardised approach for counterparty credit risk (SA-CCR) where the PRA considers it to be overly conservative, and remove certain existing exemptions from CVA capital requirements for transactions that the PRA considers have material CVA risk.
- **Chapter 8 – Operational risk** – This chapter sets out the PRA's proposals to implement the Basel 3.1 standards for operational risk. The new operational risk capital framework aims to help ensure that firms maintain sufficient financial resources to mitigate the risk of loss due to inadequate or failed internal processes, people or systems, or from external events. The new operational risk framework is proposed to replace the existing methodologies.
- **Chapter 9 – Output floor** – This chapter sets out the PRA's proposals to implement the Basel 3.1 standards for the output floor with respect to firms' calculation of RWAs, which would limit the RWA reductions available to firms through their application of IMs.
- **Chapter 10 – Interactions with the PRA's Pillar 2 framework**[23] – This chapter contains no specific proposals, but describes at a high level the implications of the proposed changes to the Pillar 1 risk-weighting framework, as set out in this CP, for the PRA's Pillar 2 framework.
- **Chapter 11 – Disclosure (Pillar 3)** – This chapter sets out the PRA's proposals to update the UK Pillar 3 disclosure requirements to reflect the proposals set out elsewhere in this CP. The proposals aim to align the Pillar 3 disclosures of UK firms to the Basel 3.1 standards for Pillar 3 disclosure requirements.
- **Chapter 12 – Reporting** – This chapter sets out the PRA's proposals to align PRA supervisory reporting requirements with the proposals set out elsewhere in this CP.
- **Chapter 13 – Currency redenomination** – This chapter sets out the PRA's proposals to change certain Euro (EUR) and US Dollar (USD) references to Pound Sterling (GBP).

Changes to PRA rules and policy materials

1.61 The proposals set out in this CP would result in changes to the following parts of the PRA Rulebook and existing policy materials:[24]

Proposed changes to policy material

Policy material	Proposals
PRA Rulebook (CRR) Instrument 2023	**The instrument would introduce new Parts of the PRA Rulebook, as follows:** Required Level of Own Funds (CRR) Credit Risk: General Provisions (CRR) Credit Risk: Standardised Approach (CRR) Credit Risk: Internal Ratings-Based Approach (CRR) Credit Risk Mitigation (CRR) Market Risk: General Provisions (CRR) Market Risk: Internal Model Approach (CRR) Market Risk: Advanced Standardised Approach (CRR) Market Risk: Simplified Standardised Approach (CRR) Credit Valuation Adjustment Risk Operational Risk
PRA Rulebook (CRR) Instrument 2023	**The instrument would amend the following Parts of the PRA Rulebook:** Credit Risk Standardised Approach and Internal Ratings Based Approach to Credit Risk (CRR) Trading Book (CRR) Market Risk Credit Valuation Adjustment Risk (CRR) Counterparty Credit Risk (CRR) Benchmarking of Internal Approaches Operational Risk (CRR) Regulatory Reporting

	Reporting Pillar 2 Reporting (CRR) Disclosure (CRR) Interpretation Glossary
Supervisory Statements (SS)	**This CP would amend:** Credit risk: standardised approach (**SS10/13**)[25] Underwriting standards for buy-to-let mortgage contracts (**SS13/16**) (see footnote 25) Market risk (**SS13/13**) (see footnote 25) Counterparty credit risk **(SS12/13**) (see footnote 25) Credit risk mitigation (**SS17/13**) (see footnote 25) Guidelines for completing regulatory reports (**SS34/15**) (see footnote 25) **This CP would delete:** Internal Ratings Based approaches (**SS11/13**)[26] Operational risk (**SS14/13**) (see footnote 25) **This CP would introduce:** Draft SS 'Credit Risk: Definition of Default'[27] Draft SS 'Credit Risk: internal ratings based approaches' (see footnote 27)
Statements of Policy (SoP)	**This CP would amend:** SoP **'Interpretation of EU Guidelines and Recommendations: Bank of England and PRA approach after the UK's withdrawal from the EU**'[28] **This CP would introduce:** Draft SoP 'Operating the Simpler-regime criteria: Statement of Policy'

1.62 Appendix 4 of this CP sets out the proposed draft rules in full, including parts of the CRR that are not intended to be amended, but are being transferred to and restated in the PRA Rulebook for coherence and ease of use. Where the text is being restated and not amended, it does not form part of this CP. Appendix 9 also includes draft rules for the Transitional Capital Regime, which includes the draft rules for the Simpler-regime criteria.

References to CRR

1.63 Where the proposed new Rulebook parts are a mix of new material and material that largely restates existing provisions of the CRR, they have been written in a style and structure that maintains consistency with CRR, with article numbers that, where possible, correspond to the CRR. This is for ease of reference for firms as the framework is transitioned from CRR in primary legislation to PRA rules and to ensure workability with those parts of the CRR framework that remain in primary legislation. However, for risk areas where the existing approaches have been entirely replaced with revised approaches, the rules have been written in a style and structure that more closely aligns to other material in the existing PRA Rulebook and to the PRA's long-term aspiration to have a clear, coherent, and accessible Rulebook.[29] The table of revoked CRR provisions and their corresponding **PRA rules** will be updated in due course.

Implementation

1.64 The PRA proposes that the implementation date for the changes resulting from this CP, other than those affected by transitional provisions set out below, would be Wednesday 1 January 2025.

Transitional provisions

1.65 The PRA proposes to implement transitional provisions for the output floor. The transitional period follows that set out in the Basel 3.1 standards and would cover a five-year period beginning on the PRA's proposed implementation date of Wednesday 1 January 2025. Further details of transitional arrangements for the output floor can be found in Chapter 9.

1.66 The PRA also proposes to apply a five-year transitional period starting from the proposed implementation date of Wednesday 1 January 2025 for SA and IRB firms for the implementation of the revised treatment of equity exposures in the credit risk SA. Further details of the transitional periods for equity exposures can be found in Chapters 3 and 4.

1.67 In the CVA framework (Chapter 7), the PRA proposes to apply a five-year transitional treatment under which only legacy trades that would be exempt from CVA RWAs prior to the application of the new CVA requirements set out in this CP, remain exempted. Firms would, however, have the option to irreversibly apply the new CVA requirements to these trades instead.

1.68 In the SA-CCR framework (Chapter 7), the PRA proposes to allow firms to apply the reduced alpha multiplier to trades with certain counterparties, including legacy trades with such counterparties, from the proposed implementation date of Wednesday 1 January 2025, but to require them to maintain additional Pillar 1 capital equal to the reduction in capital requirements on the proposed implementation date for the legacy trades. The additional capital requirement for the legacy trades would reduce linearly over five years.

1.69 The PRA does not intend to introduce any transitional provisions that include a review at the end of the transitional period to consider whether they should be extended. The PRA considers that to do so would create additional uncertainty for firms, which would undermine their business planning activities. In addition, transitions with uncertain endings would reduce the speed of convergence with international standards.

Timeline and process for permissions within the Basel 3.1 standards

Market risk and CVA

1.70 On Monday 27 June 2022, the **PRA issued a letter to firms** detailing its timetable for submission of IM and SA pre-applications with respect to the revised market risk framework. The proposals set out in this CP would make existing IM permissions for market risk redundant. Current IMA firms would; therefore, automatically move to the ASA unless granted a new IMA permission.

1.71 As set out in the letter, the PRA would expect firms to submit final pre-application materials for new IMA permissions at least 12 months before the proposed implementation date of Wednesday 1 January 2025 for the proposals set out in this CP. Any submissions after this date may require the firm to use the SA at least for an initial period, pending the completion of the PRA's model review. Firms that submit by the requested date would be given priority during the PRA's review.

1.72 With respect to areas of the ASA that require permission, the PRA would expect firms to submit any related pre-application materials at least 12 months before the proposed implementation date of Wednesday 1 January 2025.

1.73 The PRA would expect firms to submit final pre-application materials for new SA-CVA permissions at least 12 months before the proposed implementation date of Wednesday 1 January 2025.

CRR permissions

1.74 Where firms' existing permissions were issued under provisions of CRR that are expected to be revoked as a consequence of the proposals set out in this CP, HMT has stated in its consultation published on or around the date of this CP that it expects to use the power in s.3(5) of the Financial Services Act 2021 to make provisions saving the effect of the granting of those permissions if appropriate. Please see the relevant chapters of this CP for information on specific permissions.

Responses and next steps

1.75 This consultation closes on Friday 31 March 2023. The PRA invites responses on any aspect of the proposals set out in this consultation, as well as any data or evidence that is pertinent to such proposals. This CP includes a number of questions in Chapters 2 to 9 to which the PRA would welcome responses, but the PRA would welcome responses on all aspects of the CP (see Appendix 2 for a full list of specific questions). The PRA also invites stakeholders to bring to the PRA's attention any relevant issues that are not addressed in the proposals set out in this CP. Please address any comments or enquiries to CP16_22@bankofengland.co.uk.

1.76 Please indicate in your response if you believe any of the proposals in this CP are likely to impact persons who share protected characteristics under the Equality Act 2010, and if so, please explain which groups and what the impact on such groups might be.

Navigation guide

1.77 This CP is divided into 13 separate chapters[30] and 20 appendices that are set out at the end of each relevant chapter (a full list of appendices is provided in Appendix 3). Each chapter contains a set of proposals, except for Chapter 10. You can use the next chapter and previous chapter buttons at the bottom of this webpage to navigate between chapters. You can also select the title of the specific chapter in the navigation pane to the left of this page and at the top of this page. You can download a copy of each chapter in PDF by selecting the 'Convert this page to PDF' button at the top right-hand corner of the webpage.

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1. Throughout this CP, the PRA uses the term 'risk-weighted assets' since it is commonly understood in the industry, as equivalent to 'risk-weighted exposure amounts' which is the term used in the CRR and proposed rules.

2. This was done through the onshored and amended UK version of Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, referred to as the 'CRR' in this CP and related onshored EU level 2 regulations that are made under the CRR (CRR level 2 Regulations).

3. As set out in paragraph 1.7 of this chapter. Note that the PRA is not consulting in this CP on the implementation of minimum haircut floors for securities financing transactions (SFTs) in the capital framework – one of two approaches envisaged in the FSB's report Regulatory framework for haircuts on non-centrally cleared securities financing transactions. The PRA will consider whether implementation in the capital framework is appropriate in due course, taking into account data available under SFT reporting.

4. Throughout this CP, the PRA uses the term 'capital requirements' since it is commonly understood in the industry as equivalent to 'own funds requirements', which is the term used in the CRR and proposed rules.

5. Sometimes referred to as the 'Fundamental Review of the Trading Book'.

6. The use of a common set of exposures was intended to largely eliminate differences in risk between firms, so that remaining variation would be due to differences in firms' models and in supervisory practices.

7. Major UK banks are Barclays, HSBC, Lloyds Banking Group, Nationwide, NatWest Group, Santander UK, and Standard Chartered. Aggregate risk-weight is defined as RWAs divided by total balance sheet assets. RWAs are defined using the prevailing regulatory standards at each data. Alternative measures of aggregate risk weights, for example dividing RWAs by the Basel III exposure measure or the UK leverage exposure measure, show a similar downward trend once adjusted for differences in levels.

8. The 'boundary' defines how positions are allocated to either the trading book or the non-trading book. This allocation determines whether they are treated under the market risk or credit risk framework.

9. The onshored and amended UK version of Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, referred to as the 'CRR' in this CP.

10. The proposed CRR revocations are set out in the **HM Treasury consultation** published on the same day as this CP .

11. The PRA has primarily considered the proposals of Canada, Singapore, and Switzerland, as well as the proposals of the European Commission in detail, as they stood at the time of the PRA's policy-making process. At the time of publication, the USA had not issued its proposals. The PRA intends to continue to monitor the proposals of the USA and other major jurisdictions as they evolve and consider these before finalising its own proposals.

12. The ECB and EBA state that, if adopted, these deviations could lead to the BCBS labelling the EU 'non-compliant', the lowest possible grade.

13. **Financial services: contribution to the UK economy - House of Commons Library**.

14. Where specific analysis has not been provided against a 'have regard' for a proposal, it is because in the PRA's assessment that 'have regard' did not give rise to material issues for consideration with respect to that proposal.

15. This includes societies registered under the Industrial and Provident Societies Act 1965 (or its predecessors) that were previously referred to as 'industrial and provident societies' and are now legally referred to 'registered societies' under the Co-operative and Community Benefit Societies Act 2014.

16. For the avoidance of doubt, credit unions are excluded from the proposed scope of application.

17. See Appendix 7 for the aggregated cost benefit analysis, which should be read in conjunction with the individual policy chapters.

18. See CP5/13 – **'Strengthening Capital Standards: Implementing CRD IV'**, which sets out the PRA's approach to estimating the benefits of increased capital in the system and includes research linking higher capital to a decreased likelihood of future financial crises.

19. Paragraphs 4.25-4.26 in DP1/21.

20. Chart 4 in PRA Feedback Statement 1/21 – **Responses to DP1/21 'A strong and simple prudential framework for non-systemic banks and building societies', December 2021.**

21. On the planned phases of the development of the simpler regime, see paragraph 1.14 in CP5/22 – **'The Strong and Simple Framework: a definition of a Simpler-regime Firm'**. Phase 2 covering capital requirements will follow Phase 1 mainly covering liquidity requirements.

22. The denominator of the leverage ratio which is defined as the ratio of capital to exposures.

23. This topic is included in this CP for completeness. The PRA does not propose any new policy in this chapter.

24. Changes for Basel 3.1 purposes do not apply in respect to firms in the Transitional Capital Regime, unless this is done expressly. The existing policy material would continue in effect as appropriate for firms within the 'Strong & Simple' Transitional Capital Regime.

25. The PRA proposes that the current version of the statement will apply in respect to firms subject to the Transitional Capital Regime.

26. The PRA proposes that chapter 11 of the current version of the statement will apply in respect to firms subject to the Transitional Capital Regime.

27. The PRA proposes that this statement will not apply in respect to firms subject to the Transitional Capital Regime, except to the extent those firms are applying for an IRB permission.

28. The PRA proposes that the current version of the statement will apply in respect to firms subject to the Transitional Capital Regime, but for the 'Guidelines on disclosures of encumbered and unencumbered assets' listed in Appendix 2 of the statement. Those guidelines will no longer be applicable because they have been superseded by Article 443 of the Disclosure (CRR) Part of the PRA Rulebook.

29. See DP4/22 – **'The Prudential Regulation Authority's future approach to policy'**, which sets out for discussion the PRA's vision for its approach to policy, including accessibility of the PRA Rulebook.

30. Throughout this CP, for accessibility purposes, we have generally not capitalised the names of methods, exposure classes, and similar definitional terms, but have generally emphasised them by using single quote marks on first usage in each chapter.

Appendices

- Appendix 1: Abbreviations (PDF 0.7MB)
- Appendix 2: List of questions (PDF 0.8MB)
- Appendix 3: List of appendices (PDF 0.8MB)
- Appendix 4: Draft PRA Rulebook (CRR) Instrument [2023] (PDF 4.1MB)
- Appendix 5: Draft PRA Standards Instrument: Technical Standards (Economic Downturn) Revocation Instrument [2023] (PDF 0.1MB)
- Appendix 6: PRA statutory obligations (PDF 0.8MB)
- Appendix 7: Aggregated cost benefit analysis (CBA) (PDF 1.2MB)
- Appendix 8: Draft amendments to Statement of Policy – 'Interpretation of EU Guidelines and Recommendations: Bank of England and PRA approach after the UK's withdrawal from the EU' (PDF 0.8MB)

Next chapter

CP16/22 – Implementation of the Basel 3.1 standards: Scope and levels of application

Chapter 2 of CP16/22

Published on 30 November 2022

Content

Overview

2.1 This chapter sets out the Prudential Regulation Authority's (PRA) proposed scope and levels of application for the proposals outlined in this Consultation Paper (CP).

2.2 The proposals in this chapter would affect the scope and levels of application of the following proposed new Capital Requirements Regulation (CRR) Parts of the PRA Rulebook to implement the Basel 3.1 standards:

- Required Level of Own Funds (CRR)
- Credit Risk: General Provisions (CRR)
- Credit Risk: Standardised Approach (CRR)
- Credit Risk: Internal Ratings Based Approach (CRR)
- Credit Risk Mitigation (CRR)
- Market Risk: General Provisions (CRR)
- Market Risk: Internal Model Approach (CRR)
- Market Risk: Advanced Standardised Approach (CRR)
- Market Risk: Simplified Standardised Approach (CRR)
- Credit Valuation Adjustment Risk
- Operational Risk

2.3 The proposals in this chapter would also result in a new (CRR) Part of the PRA Rulebook to implement a Transitional Capital Regime available to firms meeting the Simpler-regime criteria:

- Simpler regime Transitional Capital Regime (see paragraphs 2.15 to 2.27)

2.4 The proposals included in this chapter are:

- replicating the CRR scope of application for the purposes of implementing the Basel 3.1 standards, except for TCR firms and TCR consolidation entities (see below);
- replicating the CRR levels of application for the purposes of implementing the Basel 3.1 standards, except for the output floor (for which different levels of application are proposed in Chapter 9 – Output floor);
- introducing a revised version of the scope criteria consulted on in CP5/22 – **'The Strong and Simple Framework: a definition of a Simpler-regime Firm**' (taking into account the responses to CP5/22) as the basis for determining which firms would be required to

implement the Basel 3.1 standards; those criteria are referred to as the Simpler-regime criteria;

- introducing a capital regime containing rules for risk-based capital requirements substantively the same as those currently applicable under the CRR (the 'Transitional Capital Regime') available to firms meeting the Simpler-regime criteria on 1 January 2024, during the interim period between the PRA's proposed implementation date for the Basel 3.1 standards (1 January 2025) and the future implementation date for an intended permanent risk-based capital framework for the simpler regime;[1]
- setting out the PRA's intention to offer firms that meet the Simpler-regime criteria on 1 January 2024 a modification by consent to access the Transitional Capital Regime; and
- replicating the effect of CRR provisions relating to prudential consolidation[2] for the purposes of implementing the Basel 3.1 standards and the Transitional Capital Regime.

2.5 The proposals set out in this chapter aim to ensure the PRA's proposed implementation of the Basel 3.1 standards is applied to relevant firms at appropriate levels of application and to advance the PRA's statutory objectives. The proposed Transitional Capital Regime aims to ensure small firms do not have to apply the PRA's Basel 3.1 rules before moving onto a permanent risk-based capital framework under the simpler regime.

Scope and levels of application

Scope of application

2.6 The CRR requirements currently apply to PRA-authorised banks, building societies, PRA-designated investment firms, and PRA-approved or PRA-designated financial holding companies or mixed financial holding companies ('firms'). For mutuals, the CRR requirements are only applied to building societies.[3]

2.7 For the purposes of implementing the Basel 3.1 standards, the PRA proposes to replicate the scope of application under the CRR, except for TCR firms and TCR consolidation entities, which are addressed separately in the 'Strong and simple framework: Approach for firms that meet the proposed Simpler-regime criteria' section of this chapter. This aims to ensure that prudential measures continue to be applied to the relevant firms.

Levels of application

2.8 Prudential requirements may be applied at the level of an individual firm, its consolidated group, or a sub-group of which it is a member.

2.9 The CRR requirements are currently applied at the following levels:

- firms (including ring-fenced bodies (RFBs)) on an individual entity basis;[4]

- groups of entities containing one or more firms on a consolidated basis, as though they were a single entity;[5] and
- in certain circumstances, sub-groups containing one or more firms (eg RFB sub-groups) on a sub-consolidated basis.[6]

2.10 For the purposes of implementing the Basel 3.1 standards, the PRA proposes to make rules replicating the levels of application that currently apply to Part 3 (Capital Requirements) of the CRR, except for the output floor (for which different levels of application are proposed in Chapter 9).

PRA objectives analysis

2.11 The PRA has assessed the proposals in this section and consider the proposed approach on scope and levels of application would best advance its primary and secondary objectives. The analysis presented for this section excludes consideration of the proposed levels of application for the output floor (see Chapter 9) and the application of the Basel 3.1 standards to firms that meet the Simpler-regime criteria (see 'Strong and simple framework: Approach for firms that meet the proposed Simpler-regime criteria' section of this chapter). As such, 'firms' here refers to firms within the PRA's proposed scope of application for the Basel 3.1 standards.

2.12 The PRA considers the proposals in this section would advance the safety and soundness of firms by ensuring that firms within the scope of application of the Basel 3.1 standards (and their wider groups, where applicable) are adequately capitalised at the consolidation level as well as at the sub-consolidation and individual entity levels. This would help ensure that capital is allocated where risks arise, safeguarding the financial resilience of firms, their groups, and sub-groups against adverse shocks and stresses. Adequately capitalised firms and groups would also facilitate more orderly resolvability, where necessary.

2.13 The PRA considers the proposals in this section advance its secondary competition objective. The PRA considers that having the scope and levels of application provisions within the PRA's rules would improve their clarity and accessibility for firms given the rules would be located in the PRA Rulebook alongside other rules within the same policy area. The PRA considers this approach would reduce the complexity of own funds requirements which in turn reduces barriers to entry for new firms.

'Have regards' analysis

2.14 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA),

the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Relative standing of the UK as a place to operate (FSMA CRR rules) and competitiveness (HMT recommendation letters):

- By ensuring that the Basel 3.1 standards are applied to relevant firms at the appropriate levels, the PRA considers the proposals in this section would preserve the UK's reputation for having a robust regulatory environment for doing financial services business, ensuring it remains an attractive domicile for internationally active financial institutions.

2. Finance for the real economy (FSMA CRR rules) and sustainable growth (FSMA regulatory principles and HMT recommendation letters):

- The PRA considers the proposals in this section would help ensure that firms are adequately capitalised at appropriate levels, strengthening their financial resilience and ability to provide financial services to the real economy through the economic cycle to support sustainable growth. In particular, the application of the Basel 3.1 standards at the sub-consolidation level would protect UK retail banking, a source of key financial services the real economy relies on, from shocks originating elsewhere in the group and from global financial markets. Adequate capitalisation of firms would also facilitate their resolvability, if necessary, avoiding significant disruption to the wider economy. The proposals in this section would thus promote greater financial stability and support the sustainable growth of the wider UK economy.

3. Relevant international standards (FSMA CRR rules):

- The PRA considers the proposals in this section are aligned with the Basel 3.1 standards.

Strong and simple framework: Approach for firms that meet the proposed Simpler-regime criteria

2.15 In CP5/22 – 'The Strong and Simple Framework: a definition of a Simpler-regime Firm', the PRA set out its intention to consider whether and how firms meeting the proposed scope criteria for the simpler regime should be included in the scope of application of the PRA's implementation of the Basel 3.1 standards.

2.16 The PRA has started its analysis of the appropriate capital framework for the simpler regime (covering Pillar 1 and Pillar 2 minimum capital requirements and capital buffers requirements) but has not concluded its considerations at this stage; see paragraphs 1.55 to 1.56 of Chapter 1 – Overview.

2.17 This CP proposes a Transitional Capital Regime so that small firms do not need to apply the Basel 3.1 standards before the future implementation date for a permanent risk-based capital framework for the simpler regime, and so that they remain subject to a regime based on the existing CRR provisions until that time. In CP5/22, the PRA proposed draft scope criteria for the simpler regime that it is developing. Box A explains how the draft scope criteria have been revised to reflect responses to CP5/22. In this CP, the PRA proposes to use those revised criteria to determine the firms that would be able to choose to be subject to the Transitional Capital Regime.

2.18 The PRA proposes that firms meeting the Simpler-regime criteria on 1 January 2024 can choose between being subject to the Basel 3.1 standards on the same timetable as other firms to which the new rules apply (see Chapter 1, 'Implementation' section), or being subject to the Transitional Capital Regime that would be in place until the implementation date of a permanent risk-based capital framework for the simpler regime. As discussed in CP5/22, this would help ensure that small firms do not have to experience more than one change to the applicable risk-based capital framework, as well as enabling small firms to apply the Basel 3.1 standards at the earliest opportunity in the cases where firms considered it appropriate given the nature and scale of their activities. See Appendix 9 for the draft rules for the Transitional Capital Regime.

2.19 A firm that is part of a group based in the UK that meets the Simpler-regime criteria as of 1 January 2024 would be invited to consent to a modification to be subject to the Transitional Capital Regime if it chooses to (provided that any other bank or building society in its consolidation group is also willing to consent to the modification at the same time). In the draft rules, any firm that consents to this modification is a 'TCR firm'. If all PRA-authorised firms in a consolidation group are TCR firms, the CRR consolidation entity is a 'TCR consolidation entity', which would also be subject to the Transitional Capital Regime. A firm that meets the Simpler-regime criteria on 1 January 2024 that does not consent to the modification would implement the Basel 3.1 standards on the PRA's proposed implementation date of 1 January 2025.

2.20 A firm that is part of a group based outside of the UK – be that a subsidiary of a foreign headquartered banking group or a firm with a foreign holding company – cannot meet the Simpler-regime criteria but could apply for a modification of the criteria that would enable it to be subject to the Transitional Capital Regime. The draft Statement of Policy included in Appendix 10 sets out circumstances in which the PRA considers that it is likely to be possible (subject to the statutory conditions being met) to grant a modification to the Simpler-regime criteria that would enable a firm that is part of a group based outside of the UK to consent to the modification for application of the Transitional Capital Regime.

2.21 The PRA intends to publish the draft modification directions and the terms on which the directions would be offered in due course.

2.22 If a firm that has a modification direction to be subject to the Transitional Capital Regime ceases to meet the scope criteria between 1 January 2024 and the implementation date of the permanent risk-based capital framework for the simpler regime, it would be required to notify the PRA. In many cases, such firms should have been able to prepare for ceasing to meet the Simpler-regime criteria and should; therefore, be able to comply with the Basel 3.1 standards almost immediately. In some circumstances, a firm might reasonably need some limited further time to prepare for complying with the Basel 3.1 standards. The PRA would consider this when deciding when to revoke the firm's modification, at which point any incidental matters such as the treatment of existing permissions will be considered and addressed. In the event that a firm ceases to meet the scope criteria because it receives a permission to use an internal ratings based (IRB) approach model, the PRA would engage with the firm in the period before the IRB permission approval was made to help ensure the firm is ready to move from the Transitional Capital Regime to the Basel 3.1 standards.

2.23 For the proposed Transitional Capital Regime, the PRA intends to make CRR rules to replace the CRR articles and technical standards that HM Treasury (HMT) intends to revoke, in order to preserve their effect as appropriate for firms meeting the Simpler-regime criteria. In some cases, this would entail a simple reinstatement by reference of the CRR articles or technical standards being revoked. In other cases, the CRR articles and technical standards include a provision which cannot simply be reinstated. For example, some of the CRR articles and technical standards include obligations on HMT to make regulations and, more generally, obligations on the PRA, which PRA rules cannot appropriately impose.

2.24 In order to help ensure that the existing requirements in the relevant CRR articles and technical standards would be legally operable as rules, the PRA would need to make certain amendments.[7] These are set out in the proposed modifications in the draft Simpler Regime (Transitional Capital Regime) Instrument in Appendix 9. The PRA considers that these changes would not be substantial, and would only entail what is needed for the continuation of the existing requirements during the interim period, pending the development of a full proposal for capital rules for the simpler regime. The PRA also intends, in due course, to publish more details of its approach, including the powers on which it intends to rely, in order to achieve the same or similar results as the CRR articles and technical standards that HMT intends to revoke.

2.25 One area where the proposed rules do differ from the relevant CRR articles and technical standards is their scope of application. The Transitional Capital Regime would apply to the cohort of the TCR firms and TCR consolidation entities, rather than all CRR firms as is currently the case under the CRR.

2.26 HMT intends to use its powers under Section 3(5) of the Financial Services Act 2021 to make savings provisions in relation to the relevant CRR permissions that are replicated in PRA rules so that TCR firms do not need to apply for a new permission to retain their existing capital treatment.

2.27 In CP5/22, the PRA proposed that firms that wish to develop IRB models and submit an IRB application would be able to do so while continuing to meet the Simpler-regime Firm definition.[8] To enable a firm to submit an IRB application while it is a TCR firm, the scope of the proposed Basel 3.1 rules governing the IRB permission approval process would include TCR firms and TCR consolidation entities for the purpose of any such applications.

Cost benefit analysis

2.28 The Transitional Capital Regime may result in modest benefits and costs. The benefits to firms that meet the Simpler-regime criteria derive primarily from the avoidance of operational compliance costs necessary to understand and operationalise the Basel 3.1 standards. Appendix 7 (see section C) estimates these to be in the order of £45 million for the banks and building societies that the PRA estimates would meet the proposed criteria in CP5/22 if those criteria were in place now.[9] The Transitional Capital Regime may produce additional benefits to the extent that, by providing certainty about capital requirements during the interim period between the proposed implementation date of the Basel 3.1 standards and the future implementation date for an intended permanent risk-based capital framework for the simpler regime, it helps firms avoid costs of adjusting business models and balance sheets under two different capital regimes (ie first under the Basel 3.1 standards and then under the subsequent simpler regime). During the interim period, it is possible that TCR firms incur opportunity costs to the extent that capital requirements are higher under the Transitional Capital Regime compared with the Basel 3.1 standards. These costs however, would depend on the degree to which TCR firms' assets have lower SA risk weights under the Basel 3.1 standards. Since firms meeting the Simpler-regime criteria would have the option of applying the Basel 3.1 standards, such costs would be expected to be minimal.

PRA objectives analysis

2.29 The PRA considers that the proposals in this section advance its primary objective. The use of the Transitional Capital Regime allows the PRA to maintain the safety and soundness of TCR firms while developing a regime appropriate for small firms.

2.30 The PRA considers that the proposed Transitional Capital Regime would advance its secondary competition objective as the PRA considers that by introducing the Transitional Capital Regime, small firms could avoid the unnecessary regulatory burden of having to go through two changes to the risk-based capital framework. The PRA considers this approach would support TCR firms' ability to compete effectively. Further, firms in the Transitional Capital Regime that benefit from the refinements to Pillar 2A,[10] which reduce the differences between risk weights in the standardised approach to credit risk (SA) and risk weights in the IRB approach, would continue to do so.

'Have regards' analysis

2.31 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Proportionality (FSMA regulatory principles):

- The PRA considers the proposed Transitional Capital Regime is a proportionate approach to manage the interim period between the proposed implementation date for the Basel 3.1 standards and the future implementation date of the risk-based capital framework for the simpler regime. The proposed approach would allow firms meeting the Simpler-regime criteria to remain subject to a capital framework which currently applies to them. The PRA also considers the Transitional Capital Regime avoids placing unnecessary burden and costs on these firms, which could reduce their safety and soundness, by requiring them to incur the costs of two changes to the applicable risk-based capital framework.

2. Finance for the real economy (FSMA CRR rules) and sustainable growth (FSMA regulatory principles and HMT recommendation letters):

- The PRA considers a Transitional Capital Regime would avoid placing an unnecessary regulatory burden on firms meeting the Simpler-regime criteria because a firm would not have to incur the costs of moving onto the Basel 3.1 standards before incurring the costs of moving onto the risk-based capital framework designed for small firms that the PRA intends to develop. The PRA considers that the proposed approach would avoid disruption to these firms and therefore support their continued provision of finance to the real economy and allows these firms to continue supporting sustainable economic growth.

3. Different business models (FSMA regulatory principles):

- The proposals in this section recognise differences in the nature of firms' business models. The proposed Simpler-regime criteria include firms' size, trading activities, and domestic exposures. Further, the proposed Transitional Capital Regime, which firms would be familiar with, avoids placing a potentially unnecessary regulatory burden on small firms of having to adapt to a new capital framework and any associated costs which could reduce their safety and soundness.

4. Relevant international standards (FSMA CRR rules):

- The PRA considers the proposals in this section conform with the Basel 3.1 standards as the option to be subject to the Transitional Capital Regime, rather than the Basel 3.1 standards, only applies to firms the PRA considers to be domestically focused.

5. Mutuals (FSMA obligation):

- The PRA has an obligation to give an opinion on the impact of its proposals on mutual societies (s138K FSMA), ('mutuals'). The PRA expects building societies (the only group of mutuals within the scope of the proposals) to be among the firms eligible to enter the Transitional Capital Regime.

Question 1: Do you have any comments on the PRA's proposals for the Transitional Capital Regime?

Box A: A revised version of the scope criteria consulted on in CP5/22

1. In CP5/22, the PRA consulted on a definition of a Simpler-regime Firm and the criteria in this definition. This is a definition of a type of firm that would be subject to a simpler, but robust, set of prudential rules in the future. The PRA considers that this regime should advance the PRA's primary safety and soundness objective and facilitate effective competition, thereby supporting its secondary objective.

2. This box summarises responses to CP5/22 and sets out reasons why the PRA considers the proposed criteria should be revised with a view to the future use of those criteria to determine whether firms would be eligible for the future simpler regime.

3. The PRA received 19 responses to CP5/22. As a result, the proposed revisions are set out below in Table 1. The PRA also considered other comments made by respondents, but has decided not to revise the criteria in response to those comments at this stage. The PRA intends to provide a final response to CP5/22 in due course.

4. Since the purpose of the Transitional Capital Regime is to enable small firms to not have to apply the Basel 3.1 standards before the future implementation date for a permanent risk-based capital framework for the simpler regime, the PRA proposes to use these revised criteria as the basis for determining which firms are eligible for the Transitional Capital Regime.

5. The PRA expects to publish proposals for the first phase of simplified prudential requirements for small firms within the first half of 2023[11] and intends to propose to use the revised criteria presented here as the basis for determining firms in scope of

those proposals. The PRA also intends to explain how it plans to review the scope criteria, including the calibrations of the thresholds within those criteria, when it makes those proposals in the future.

6. Respondents to CP5/22 also made comments about the potential changes to prudential requirements under the strong and simple framework. The PRA acknowledges these comments and intends to consider them as it develops proposals for requirements in the strong and simple framework.

Cost benefit analysis

7. The PRA considers the revised criteria would increase the benefits of introducing the Simpler-regime criteria. The baseline for this assessment is that the scope criteria set out in CP5/22 were introduced.

8. The revisions could increase the number of firms that would be eligible for simplified prudential rules under the simpler regime that the PRA intends to introduce in the future, as well as for the Transitional Capital Regime. This would mean that the benefits associated with those rules could be experienced by a wider set of firms.

9. The revisions may make the measures that underpin the proposed criteria more complex for firms to calculate. For example, the revised limited trading activity criterion requires a firm to check data against limits at several points in time, rather than at just one point in time. However, the PRA does not consider the added complexity would generate significant additional costs for firms.

PRA objectives analysis

10. The proposed scope criteria would enable the PRA to propose changes to prudential regulation for firms meeting these criteria, to simplify regulation for these firms while maintaining their resilience. Overly complex prudential requirements for small firms could increase their costs which could undermine their safety and soundness.

11. The revisions could increase the number of firms that meet the criteria compared with the scope criteria set out in CP5/22 and therefore benefit the PRA's primary objective to promote safety and soundness.

12. In considering how much the size threshold in the criteria could be increased, the PRA has considered the trade-off between the benefits of greater headroom for nominal balance sheet growth and the capacity to simplify prudential regulation for small firms in the future while maintaining their resilience. The PRA might be unable to simplify rules for the bulk of smaller firms, while maintaining resilience, as much if

relatively larger firms were in scope of the simpler regime. The PRA's strong and simple project proposes to address the issues facing larger non-systemic firms separately.

13. The PRA considers that the revisions, which introduce smoothing into several of the scope criteria, would reduce the risk of firms temporarily failing to meet the Simpler-regime criteria due to unexpected shocks to the measures that underpin the criteria, or of firms having to take costly actions in response to shocks to help ensure they continue to meet the criteria. This would benefit the PRA's statutory objective to promote safety and soundness.

14. The PRA considers that smoothing would give firms more certainty about their ability to continue to be in a simpler regime in the future, and that this avoids the potential higher costs of overly complex prudential regulation. The PRA considers this could encourage new firms to enter the banking sector, which in turn supports the PRA's secondary competition objective.

'Have regards' analysis

15. In developing the revisions to the scope criteria, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of proposals in this box and the proposed revisions to the scope criteria detailed in Table 1 below:

1. Finance for the real economy (FSMA CRR rules) and sustainable growth (FSMA regulatory principles and HMT recommendation letters):

- In CP5/22, the PRA proposed a maximum size threshold of £15 billion in total assets as a scope criterion on the basis that this threshold would help ensure firms have room for growth within the simpler regime. In reviewing respondents' submissions, the PRA has analysed the risk of firms growing out of the regime, and considers that raising the threshold to £20 billion in total assets would help ensure firms have room to grow while gaining the benefit of the simplifications in the simpler regime. In addition, the PRA considers extending smoothing provisions to the limited trading activity and domestic activity criteria would reduce the risk that a firm might unintentionally breach the criteria. The PRA considers this approach would contribute to the provision of finance to the real economy and sustainable growth by small firms.

2. Proportionality and different business models (FSMA regulatory principles):

- The PRA acknowledges respondents' comments that mortgage lending to borrowers resident overseas and secured on UK property should be treated as domestic activity for the purposes of the domestic activity criterion. The PRA considers that the revised treatment of these exposures recognises the business models of different firms and demonstrates proportionality.

3. Mutuals (FSMA obligation):

- The PRA has an obligation to give an opinion on the impact of its proposals on mutual societies (s138K FSMA) ('mutuals'). The PRA expects the Simpler-regime criteria would capture building societies (the only group of mutuals within the scope of the proposals).

Table 1: Proposed revisions to the scope criteria in CP5/22

Element	Proposal in CP5/22	Responses to CP5/22	Proposed revision
Size criterion	A maximum size threshold of £15 billion.	Two respondents argued that the size threshold should be increased or indexed to give more room for nominal balance sheet growth. One respondent suggested the threshold should be aligned with the top of the indicative total assets threshold in the Bank of England's **Statement of Policy on its approach to setting a minimum requirement for own funds and eligible liabilities (MREL).** One respondent supported the proposed calibration of the threshold on the grounds it would give firms adequate room for growth. Two respondents argued that the threshold should be lower than £15 billion because including firms with total assets this high could reduce the degree to which the PRA would be able to simplify prudential	• Increase the maximum size threshold to £20 billion. • This threshold balances the ability to provide significant simplification for smaller firms, while increasing the size of firms captured and providing further room for growth.

		regulation for small firms.	
Limited trading activity criterion	A firm must have an on- and off-balance sheet trading business that would be equal to, or less than both 5% of the firm’s total assets and £44 million.	Two respondents suggested that the £44 million threshold should be periodically indexed so that firms would not cease to meet this threshold due to nominal balance sheet growth.	• Maintain the proposed £44 million threshold. • Allow for smoothing around the 5% of total assets and £44 million thresholds: a firm meets this criterion unless it has been above one or both thresholds for more than three months in succession, or more than half of months in the past year. These provisions are based on provisions in Article 94(7) of the Trading Book (CRR) Part of the PRA Rulebook.
Limited trading activity criterion	The sum of a firm’s overall net foreign exchange position, as defined in CRR Article 351, must be equal to or less than 2% of the firm’s own funds.	One respondent argued that an over-tight threshold could penalise firms undertaking remittances business because, although that business should typically not create significant net foreign exchange positions, associated foreign exchange flows could be unpredictable. Two respondents suggested that the 2% threshold could exclude a number of firms from the simpler regime.	• Allow for smoothing around the 2% of own funds threshold: a firm meets this criterion unless it has been above the threshold for more than three months in succession or more than half of months in the

Element	Proposal in CP5/22	Responses to CP5/22	Proposed revision
			past year. However, a firm must not breach a ceiling equal to 3.5% of own funds.
Exclusion of firms providing certain clearing, settlement, and custody services criterion	Exclude: (1) firms that, as any part of their business activity, provide clearing, settlement, custody or correspondent banking services (including by acting as an intermediary) to another bank or building society with access to the facilities or services of financial market infrastructure of which the firm is a direct or indirect member or participant, and also providing access to an exchange, other trading facility, payment system of any other financial market utility or infrastructure; and (2) firms that operate payment systems.	One respondent argued that subsidiaries providing these services to other parts of their group with access to payment systems would not pose the same prudential risks compared with the provision of these services to third-party banks or building societies. The respondent suggested this approach could reduce the ability of subsidiaries of foreign groups to be able to access the simpler regime.	• This criterion has been revised to make it clear that a firm can meet the criterion if the only banks, building societies, or non-UK credit institutions to which it provides any of these services are within its group and the services are in Pound Sterling (GBP).
Domestic activity criterion	At least 85% of a firm's credit exposures must be to obligors located in the UK, where exposures' means the exposures reported in COR001a, table C 09.04. In calculating these exposures, a firm should use the geographical location of exposures reported in COR001a, table C 09.04.	Two respondents argued that the criterion should be based on an average of the ratio of credit exposures to UK obligors to credit exposures to obligors in all countries to avoid inadvertent fluctuations around the 85% threshold causing firms to flip between meeting the Simpler-regime Firm definition and not meeting the definition.	• Introduce smoothing provisions into this criterion: the three-year average of the ratio of credit exposures to UK obligors to credit exposures to obligors in all countries must be at least 85%; and the ratio of credit exposures to UK obligors to credit exposures

		to obligors in all countries must be at least 75% at all times.
	Four respondents remarked that lending secured on UK property to a borrower that may be resident abroad should be classified as exposures to the UK, not as exposures to the jurisdiction in which the borrower is resident as they are in COR001a, table C 09.04.	• Exposures that are residential loans to individuals, secured on UK land and buildings (for the purposes of the Financial Conduct Authority's (FCA) mortgage lending and administration return (MLAR)) may be treated as exposures located in the UK for the purposes of testing whether a firm meets the domestic activity criterion (if they would not otherwise be treated as located in the UK).

Question 2: Do you have any comments on the PRA's proposed Simpler-regime criteria?

Approach for CRR provisions relating to prudential consolidation

Individual consolidation

2.32 Under the CRR, the PRA may permit firms to meet certain requirements on the basis of their consolidated situation with their subsidiaries, rather than on an individual basis. This is referred to as 'individual consolidation'.[12]

2.33 Where a firm currently has the PRA's permission to meet CRR requirements on an individual consolidation basis, the PRA proposes to make rules that automatically extend the existing determination and thereby preserve the effect of the existing permission for the purposes of implementing the Basel 3.1 standards and the Transitional Capital Regime.

Methods of prudential consolidation

2.34 The CRR grants powers to the PRA to determine methods of prudential consolidation.[13]

2.35 Where the PRA has previously made a determination on the method of prudential consolidation for a firm for the purposes of CRR requirements, the PRA proposes to make rules that automatically extend the existing permission and thereby preserve the effect of the existing determination for the purposes of implementing the Basel 3.1 standards and the Transitional Capital Regime.

Organisational structure and control mechanisms

2.36 The CRR requires firms to meet appropriate organisational structure and control mechanism requirements in order to meet requirements on a consolidated basis.[14]

2.37 The PRA proposes to make rules applying the same requirements to implement the Basel 3.1 standards.

PRA objectives analysis

2.38 The PRA considers the proposals in this section advance the primary objective of promoting the safety and soundness of firms by maintaining consistency with the existing CRR requirements. In doing so, the proposals in this section would prevent gaps in the level of prudential coverage for firms within the scope of the requirements set out in this CP, and facilitate an orderly transition to the new capital regime.

2.39 The PRA considers the proposals in this section would support the PRA's secondary objective by facilitating a smooth transition for firms moving to the new capital regime. The PRA considers the proposals in this section to be neutral on the compliance burden on firms, for example, if firms would not have to reapply for PRA permissions, and that this would avoid undue impact on smaller firms that do not have the advantage of economies of scale of larger firms. The PRA considers that the proposal to preserve CRR requirements on organisational structure and control mechanisms would be neutral on competition, helping to ensure firms continue to appropriately meet PRA requirements that are applied at the consolidation level.

'Have regards' analysis

2.40 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Proportionality and efficient use of PRA resources (FSMA regulatory principles):

- The PRA considers the proposals in this section are proportionate, as firms would otherwise be required to reapply for a permission that the PRA had previously granted, in the absence of material change in the conditions for granting these consolidation permissions. Likewise, the proposals in this section would support the efficient and economic use of the PRA's supervisory resources as this would avoid the PRA having to review and grant these permissions again.

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1. The PRA plans to consult on proposals for a permanent risk-based capital framework in Phase 2 of its simpler regime proposals.
2. CRR provisions on: (i) individual consolidation; (ii) PRA determinations on methods of prudential consolidation; and (iii) organisational structure and control mechanisms for meeting requirements on a consolidated basis.
3. CRR requirements are not applied to credit unions, friendly societies, and registered societies (including co-operative societies, community benefit societies, and societies previously referred to as 'industrial and provident societies').
4. CRR Article 6.
5. CRR Article 11.
6. CRR Article 11(6).
7. For example, Article 124 (1a) of the CRR as drafted includes an obligation on the PRA to ensure the Financial Policy Committee (FPC) is duly informed of the PRA's intention to make use of Article 124. The Prudential Regulation Committee (PRC) cannot appropriately make a rule applying to the PRA; hence the proposed Transitional Capital Regime modifies this article to remove the obligation on the PRA.
8. See paragraph 2.15 in CP5/22 – **The Strong and Simple Framework: a definition of a Simpler-regime Firm**, April 2022.

9. The PRA estimates a cost of £41 million for the banks it estimates would meet the proposed criteria in CP5/22 if those criteria were in place now and a cost of £1.9 million for the building societies it estimates would meet the proposed criteria in CP5/22 if those criteria were in place now. See Appendix 7 (section C) for more details.

10. See SS31/15 – **'The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)'**, July 2015.

11. See paragraph 1.14 in CP5/22.

12. CRR Article 9.

13. CRR Article 18.

14. CRR Article 11(1).

Appendices

- Appendix 4: Draft PRA Rulebook (CRR) Instrument [2023] (PDF 4.1MB)
- Appendix 9: Draft Simpler Regime (Transitional Capital Regime) Instrument (PDF 0.5MB)
- Appendix 10: Draft Statement of Policy – Operating the Simpler-regime criteria (PDF 1.7MB)

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CP16/22 – Implementation of the Basel 3.1 standards: Credit risk – standardised approach

Chapter 3 of CP16/22

Published on 30 November 2022

Content

Overview

3.1 The Basel 3.1 standards provide two approaches for calculating risk-weighted assets (RWAs) for credit risk – the standardised approach (SA) and the internal ratings based approach (IRB). This chapter sets out the Prudential Regulation Authority's (PRA) proposals to change SA Capital Requirements Regulation (CRR) requirements and PRA expectations in response to the Basel 3.1 standards. Proposals for updating IRB requirements and expectations are set out in Chapter 4 – Credit risk – internal ratings based approach, including proposed changes to the definition of default that are also relevant to firms using the SA. The proposed changes set out in this chapter are, however, of relevance to firms with IRB permissions that are in scope of the application of the output floor (as set out in Chapter 9 – Output floor).

3.2 The proposals in this chapter would:

- complement HM Treasury's (HMT) proposed revocation of certain CRR articles;
- introduce a new Credit Risk: Standardised Approach (CRR) Part of the PRA Rulebook relating to the SA approach to replace CRR articles that HMT plans to revoke;
- introduce a new Credit Risk: General Provisions (CRR) Part of the PRA Rulebook relating to general provisions for credit risk to replace CRR articles that HMT plans to revoke;[1]
- amend the existing Credit Risk Part of the PRA Rulebook;
- remove the Standardised Approach and Internal Ratings Based Approach to Credit Risk (CRR) Part of the PRA Rulebook (in so far as it relates to the SA); and
- amend Supervisory Statement (SS) 10/13 – 'Standardised approach' and SS13/16 – 'Underwriting standards for buy-to-let mortgage contracts'.[2]

3.3 RWAs under the SA are determined by assigning exposures to a standardised set of risk weights. For some exposure classes, external ratings can be used as the starting point for assigning SA risk weights.[3] For exposures without external ratings, SA risk weights are generally assigned according to one or more risk drivers, eg loan to value (LTV) in the case of residential mortgages.

3.4 The Basel 3.1 standards enhance the risk-sensitivity and robustness of the SA, with an aim to ensure its continued suitability for calculating RWAs, while also providing a credible alternative (and complement) to IRB. This is particularly important because in some cases where modelling is too difficult or complex, the PRA proposes to remove use of the IRB approaches, meaning that the SA needs to be a credible alternative for IRB firms.

3.5 In designing the proposed changes to the SA set out in this chapter, the PRA has sought to develop SA methodologies that are appropriate both for SA firms and for firms with IRB permissions that would be in scope of the proposed application of the output floor (as set out in Chapter 9) and need to calculate credit risk RWAs using the SA for purposes of the output floor. As set out in Chapter 9, the PRA does not consider it appropriate to tailor the SA methodologies for the purpose of the proposed output floor calculation, because it considers that a robust and consistent application of SA methodologies by IRB firms subject to the floor is necessary to achieve the prudential objectives of the output floor, and to advance the PRA's primary and secondary objectives. Assessments of how the proposed changes to SA methodologies set out in this chapter advance the PRA's primary and secondary objectives, and consideration of the various factors to which the PRA must 'have regard', have been completed on this basis.

3.6 These changes to the SA are designed to address shortcomings in global prudential standards by:

- reducing mechanistic reliance on external ratings;
- rebalancing standards towards risk-sensitivity over simplicity; and
- promoting comparability between firms (and jurisdictions) by reducing variability of risk weights.

3.7 The PRA supports the aims of the Basel Committee on Banking Supervision (BCBS) in updating the SA, as these are consistent with the PRA's primary and secondary objectives. However, the PRA considers giving practical effect to the Basel 3.1 standards requires a degree of interpretation, and raises questions around operational realities and local market specificities. Generally, the PRA is seeking to add clarity where it is likely to be beneficial for firms and supervisors, as well as proposing adjustments where appropriate, to reflect the UK market.

3.8 The package of SA rules and expectations proposed by the PRA in this consultation paper (CP) has been calibrated to deliver a level of resilience broadly aligned to the standards agreed by the BCBS, in keeping with the UK's role as a global financial centre, while addressing UK specificities and operational challenges. Specific benefits in the PRA's proposed SA package compared with existing CRR requirements include:

- enhanced risk-sensitivity, including lower risk weights for low-risk mortgage lending and the introduction of specific treatments for 'specialised lending';
- a more risk-sensitive treatment for exposures to unrated corporates, including unrated funds;
- a simpler, more transparent and prudent mechanism for determining risk weights aimed at supporting lending to small and medium-sized enterprises (SMEs);

- a more risk-sensitive approach to risk-weighting equity exposures, including a prudent treatment for higher risk ‘speculative unlisted equity’;
- off-balance sheet conversion factors (CFs) aligned to local UK market conditions; and
- a proportionate approach to SA operational requirements, including for the new due diligence requirements included in the Basel 3.1 standards.

3.9 The proposals in this chapter are relevant to PRA-authorised banks, building societies, PRA-designated investment firms, and PRA-approved or PRA-designated financial holding companies or mixed financial holding companies (‘firms’). The proposals would not apply to UK banks and building societies that meet the Simpler-regime criteria and choose to be subject to the Transitional Capital Regime proposals.[4]

3.10 In this chapter, the PRA has set out details where it proposes substantive changes to requirements and expectations relative to the existing approach. The PRA also proposes to make a number of other amendments in order to enhance the clarity and coherence of the framework. This includes consolidating some existing PRA rules into new Rulebook Parts. To the extent that the PRA does not propose to amend the existing approach, current requirements and expectations would continue to apply.[5]

External credit ratings and due diligence

3.11 This section sets out the PRA’s proposals for implementing the Basel 3.1 standards for the SA to credit risk for the use of external credit ratings and due diligence.

3.12 The BCBS considered the over-reliance on external credit ratings as a weakness of the SA, noting that external credit ratings were often being used by firms to calculate RWAs without the firms having a sufficient understanding of the underlying risks of the exposures. The BCBS concluded that it is important that firms have an understanding of the underlying risks.

3.13 The PRA shares the BCBS’s concerns and proposes changes to reduce the potential for firms to mechanistically rely on external credit ratings without themselves having a robust understanding of the risk of the exposures.

External credit ratings

3.14 The PRA proposes to change the SA requirements for the use of external credit ratings. The PRA considers that most of these changes would not materially affect the substance of the existing CRR requirements, but would align the PRA’s approach more closely with the Basel 3.1 standards. These changes would improve the clarity of the requirements for external credit ratings, which should enhance the consistency of implementation across firms.

3.15 Consistent with the Basel 3.1 standards, the PRA proposes that firms would use the credit ratings of their nominated external credit assessment institutions (ECAIs) consistently for all types of exposures, for risk management and risk-weighting purposes. The PRA considers that the proposal would reduce the potential for firms to 'cherry-pick' their use of ECAI ratings to lower RWAs by:

- ensuring that firms use ECAIs consistently for the entirety of their exposures, and preventing firms assigning preferential external credit ratings for certain exposure classes; and
- preventing firms using different ECAIs for risk-weighting than they do for risk management purposes and business decisions.

3.16 The PRA also proposes to add clarity to the SA regarding: i) issuer and issue credit ratings; ii) long-term and short-term credit ratings; and iii) domestic and foreign currency items. The PRA proposes to allow the use of unsolicited credit ratings where the unsolicited credit ratings of an ECAI do not differ in quality from the solicited credit ratings of the ECAI. Firms would not be permitted to use unsolicited credit assessments where the ECAI has used an unsolicited credit assessment to put pressure on a rated entity to place an order for a credit assessment or other services.

3.17 At this stage, the PRA does not propose to amend the mapping of the external credit ratings to the credit quality steps (CQS) set out in Commission Implementing Regulation (EU) 2016/1799 of 7 October 2016, but this will be kept under review.

Due diligence

3.18 The PRA proposes to introduce due diligence requirements comprising two elements: (i) a requirement for monitoring of counterparties; and (ii) for externally rated exposures, a requirement to increase risk weights in cases where a firm's due diligence indicates that an exposure has higher credit risk than the external credit rating would imply. The proposals are:

- **Monitoring counterparties**: Firms would need to ensure they have an adequate understanding of their counterparties' risk profiles and characteristics. The adequate monitoring of counterparties is applicable to all exposures under the SA. Monitoring would need to occur at the level of the group structure at which the exposure is held, and firms would need to take reasonable and adequate steps to assess the operating and financial condition of each counterparty. The due diligence would need to happen at the origination of the exposure and at least annually thereafter. Firms would need to ensure they have regular access to relevant information to perform the due diligence. The sophistication of the due diligence should be appropriate to the size and complexity of the firm's activities.
- **Requirement to increase risk weights**: In cases where external credit ratings are used for risk-weighting purposes, due diligence should be used to assess whether the risk

weight applied is appropriate and prudent. If the due diligence assessment suggests an exposure has higher risk characteristics than implied by the risk weight assigned to the relevant CQS of an exposure, the firm would assign the risk weight of a CQS at least one higher than the CQS indicated by the counterparty's external credit rating. This requirement is applicable to exposures to corporates, institutions, and covered bonds.[6]

3.19 At this stage, the PRA does not propose to set an expectation that the PRA would consider the due diligence analysis performed by firms as part of the Supervisory Review and Evaluation Process (SREP), but this may be reviewed at a later date.

> **Question 3: Do you have any comments on the PRA's proposed approach to the use of external credit ratings and the proposed due diligence requirements?**

PRA objectives analysis

3.20 The PRA considers that the proposals set out in this section further its safety and soundness objective by ensuring that firms take robust but proportionate measures to understand the risk of their exposures. The proposals would help ensure that firms use external credit ratings in an informed and non-mechanistic manner, reducing the likelihood that risk weights are understated and/or do not reflect the underlying riskiness of firms' exposures.

3.21 The PRA considers the proposals support its secondary objective by promoting more consistent use of external credit ratings, which would promote effective competition in the market.

'Have regards' analysis

3.22 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Competitiveness (HMT recommendation letters) and relative standing of the UK as a place to operate (FSMA CRR rules):

- The PRA expects other jurisdictions, for example the EU (based on the European Commission's proposals), to apply broadly similar requirements for the use of external credit ratings and due diligence, other than the US.[7]

2. Relevant international standards (FSMA CRR rules):

- The PRA's proposed requirements for external credit ratings and due diligence align with the Basel 3.1 standards.

Exposure values for off-balance sheet items

3.23 This section sets out the PRA's proposals for determining off-balance sheet exposure values under the SA for credit risk.

3.24 There are two categories of off-balance sheet items: (i) issued off-balance sheet items where a firm has underwritten an obligation to a third-party and stands behind the risk; and (ii) commitments to extend credit, purchase assets, or issue off-balance sheet items at a future date. The PRA proposes to differentiate between these categories more clearly in its rules.

3.25 A conversion factor (CF) is used to convert off-balance sheet items into a credit equivalent amount. The CF represents the likelihood of the exposure coming onto the balance sheet. These are then treated in the same way as an on-balance sheet exposure: (i) they are multiplied by a risk weight, which is based on the credit quality of the counterparty and exposure type, to obtain the RWAs for the exposure; and (ii) they are included in the leverage exposure measure. The proposals in this section would; therefore, impact the PRA's risk-weighted and leverage ratio frameworks.

3.26 CFs depend on the approach used to calculate RWAs for credit risk. The PRA proposes to align the foundation IRB (FIRB) approach CFs with the SA CFs, so the proposals in this section are relevant to firms using the SA and the FIRB approach. The PRA proposes to limit exposure at default (EAD) modelling under the advanced IRB (AIRB) approach to revolving commitments (see Chapter 4, 'Exposure at default (EAD) estimation' section), so the proposals in this section relating to non-revolving commitments and issued off-balance sheet items are also relevant to firms applying the AIRB approach. Where EAD can be modelled, the proposed SA CFs set out in this chapter would also impact the proposed EAD input floors (see Chapter 4, 'Exposure at default (EAD) estimation' section). Finally, the PRA proposes to prohibit EAD modelling under the slotting approach (see Chapter 4, 'Exposure at default (EAD) estimation' section), so the proposals in this section are also relevant to firms using the slotting approach.

Definition of 'commitment' for off-balance sheet items

3.27 The Basel 3.1 standards introduce a revised definition of commitment, which is based on contractual arrangements that have been entered into by firms. The PRA supports the revised definition as it would result in greater consistency across firms and, therefore, proposes to align with the Basel 3.1 standards and specify that a commitment would be considered to exist where a firm has entered into a binding contractual arrangement.

3.28 The PRA proposes that its revised definition of commitment would be used by firms to determine the point at which they need to calculate RWAs for commitments under all credit risk approaches. For firms using the IRB approach, the PRA also proposes to require firms to make further adjustments to RWAs in certain circumstances (see Chapter 4, 'Exposure at default (EAD) estimation' section).

3.29 The Basel 3.1 standards contain a national discretion to exempt certain arrangements for corporates and SMEs which meet specific criteria,[8] including in relation to the execution of drawdown, from the definition of a commitment. The PRA does not propose to exercise this discretion. While the PRA acknowledges that some of these arrangements may be unconditionally cancellable, it considers that there is still a possibility of arrangements becoming on-balance sheet exposures where a contractual relationship exists. Therefore, the PRA considers that applying zero RWAs would be inconsistent with the risk and could result in imprudent outcomes.

CF calibration for commitments

Commitments receiving a 100% CF

3.30 Firms are currently required under the CRR to apply a 100% CF to certain types of commitments that are considered to have certain or near certain drawdown. This is broadly aligned with the Basel 3.1 standards.

3.31 While the PRA does not propose to make any changes to this list of commitments subject to a 100% CF, it does propose to clarify that 'other commitments' with certain drawdown would be subject to a 100% CF.

CF calibration for note issuance facilities (NIFs) and revolving underwriting facilities (RUFs)

3.32 Under the CRR, firms using the SA currently apply a 50% CF to NIFs and RUFs, whereas firms using the FIRB approach currently apply a 75% CF. Following analysis conducted by the BCBS, the Basel 3.1 standards reduce the FIRB approach CF for NIFs and RUFs from 75% to 50% in order to align with the SA.

3.33 The PRA proposes to align with the Basel 3.1 standards and implement a 50% CF for NIFs and RUFs.

CF calibration for unconditionally cancellable commitments (UCCs)

3.34 Under the Basel 3.1 standards, UCCs include: (i) commitments that are unconditionally cancellable at any time without prior notice; and (ii) commitments that provide for automatic cancellation due to a deterioration in the borrower's creditworthiness.[9] The PRA proposes to align with this classification of UCCs.

3.35 The Basel 3.1 standards increase the CF for UCCs from 0% to 10%. The BCBS recognised that while some commitments are unconditionally cancellable by firms, in practice, other factors such as consumer protection laws, risk management capabilities, and reputational risk can prevent or discourage firms from cancelling a commitment. This means that UCCs are not riskless.

3.36 The PRA considers that non-zero RWAs should apply to commitments that are unconditionally cancellable and agrees with the justification provided by the BCBS. The PRA, therefore, proposes to increase the CF for UCCs from 0% to 10%.

CF calibration for 'other commitments'

3.37 The 'other commitments' category in the Basel 3.1 standards refers to commitments that are not NIFs or RUFs, are not subject to a 100% CF under the SA, and are not UCCs.

3.38 Other commitments are currently assigned a 20% CF under the SA if they have an original maturity of less than one year and a 50% CF otherwise. Under the FIRB approach, other commitments are currently assigned a 75% CF if they are classed as 'credit lines', otherwise the SA CFs apply.

3.39 The Basel 3.1 standards introduce a CF of 40% for other commitments regardless of maturity under the SA and the FIRB approach. After reviewing the empirical evidence, the PRA considers that a somewhat higher CF than in the Basel 3.1 standards is justified for these commitments.

3.40 First, the PRA considered evidence set out in the BCBS's 2014 CP, which indicated that a CF in the range of 50% to 75% is justified for other commitments.[10] While the BCBS ultimately decided to set a lower CF, the PRA considers that the evidence in the BCBS 2014 CP is consistent with UK industry experience of realised conversion rates for other commitments.

3.41 Second, the PRA has considered information available to it relating to realised conversion rates for mortgage offers which would typically be allocated to the other commitments category before the loan is drawn down. Based on this information, the PRA considers a 40% CF is likely to be an under-estimation of the risk of these commitments coming on balance sheet.

3.42 In view of the above, the PRA proposes to set a 50% CF for other commitments which would apply under all credit risk approaches, except where modelling is permitted under the AIRB approach.

Question 4: Do you have any comments on the PRA's proposed definition of commitment and proposed CFs for commitments?

Issued off-balance sheet items

3.43 Under the Basel 3.1 standards, issued off-balance sheet items can be identified under three broad categories: (i) direct credit substitutes, including standby letters of credit serving as financial guarantees for loans and securities; (ii) self-liquidating trade letters of credit (these include those with a maturity less than one year and those with a maturity greater than or equal to one year); and (iii) 'other transaction-related contingent items' such as performance bonds, bid bonds, warranties, and transaction-related standby letters of credit that are not credit substitutes.

Direct credit substitutes (including standby letters of credit)

3.44 Firms are currently required under the CRR to apply a 100% CF to certain types of issued off-balance sheet items that are considered to be direct credit substitutes. The PRA proposes to maintain this approach.

Short-term self-liquidating trade letters of credit (maturity less than one year)

3.45 Firms are currently required under the CRR to apply a 20% CF to trade finance documentary credits where the underlying shipment acts as collateral and to other self-liquidating trade finance collateral. The definition of trade finance set out in the CRR means this treatment can generally only be applied to exposures with a fixed maturity of less than one year.

3.46 The Basel 3.1 standards contain a similar provision. A 20% CF is applied to short-term self-liquidating trade letters of credit arising from the movement of goods where short-term is defined as being below one year. The PRA proposes to adopt the Basel 3.1 standards language and state explicitly that the 20% CF should be applied to all short-term self-liquidating trade letters of credit arising from the movement of goods with an original maturity of less than one year. The PRA considers that this proposed revised language would not result in a substantive change from the existing CRR treatment.

Self-liquidating trade letters of credit (maturity greater than or equal to one year)

3.47 The PRA also proposes to clarify the treatment for self-liquidating trade letters of credit with a maturity greater than one year, as this is not specified in the CRR. The PRA considers that these items should be assigned a higher CF than those items with maturity less than one year, in line with that applied to 'transaction-related contingent items' (set out below), because it considers that this would align with the Basel 3.1 standards and reflect the additional risk of longer maturity items. The PRA, therefore, proposes that a 50% CF would apply to self-liquidating trade letters of credit with a maturity of greater than one year.

Other transaction-related contingent items

3.48 'Transaction-related contingent items' relate to the movement of goods. Under the Basel 3.1 standards, 'other transaction-related contingent items' includes guarantees, warranties, and standby letters of credit that do not have the characteristics of credit substitutes.

3.49 The Basel 3.1 standards apply a 50% CF to 'other transaction-related contingent items'. This contrasts to the CRR approach where a 20% CF is applied to warranties and guarantees without credit substitute characteristics.

3.50 The PRA proposes to align with the Basel 3.1 standards and apply a 50% CF to the following items which it considers to be transaction-related contingent items:

- documentary credits issued or confirmed;
- documentary credits in which the underlying shipment acts as collateral and other self-liquidating transactions with maturity equal to or greater than one year (as noted above);
- warranties (including tender and performance bonds and associated advance payments and retention guarantees), and guarantees not having the character or credit substitutes;
- irrevocable standby letters of credit not having the character of credit substitutes;
- shipping guarantees, customers, and tax bonds; and
- other issued off-balance sheet items that do not have the character of credit substitutes.

3.51 The PRA has reviewed relevant empirical data and analysis relating to these transaction-related contingent items. In its assessment, the PRA has been mindful of the following considerations:

- the CF should reflect the probability of a 'trigger event'[11] occurring, which would result in the exposure moving on balance sheet, conditional on a default having occurred; and
- the CF should be reflective of behaviour in downturn conditions.

3.52 Based on its assessment, the PRA considers that the existing 20% CF does not fully reflect the risks of these items, including in relation to the points set out in the prior paragraph.

3.53 Therefore, the PRA proposes to introduce a 50% CF for transaction-related contingent items, in line with the Basel 3.1 standards. The PRA also proposes to clarify that other issued off-balance sheet items that do not have the character of credit substitutes should also be assigned to this category.

> **Question 5: Do you have any comments on the PRA's proposed CFs for issued off-balance sheet items? Do you have any additional data that the PRA could assess? In particular, do you have any data relating to the appropriate CF for 'transaction-related contingent items' in downturn conditions?**

PRA objectives analysis

3.54 The PRA considers that the proposed approaches for determining the appropriate CFs for off-balance sheet items would advance its primary objective of safety and soundness. The PRA's proposals to increase existing CRR CFs for 'other transaction-related contingent items' to align with the Basel 3.1 standards, and to apply higher CFs for 'other commitments' than specified in the Basel 3.1 standards, have been formulated in light of available data and reflect what the PRA considers an appropriate calibration to help ensure firms are adequately capitalised against off-balance sheet risks. The PRA also considers that the proposed increase in CFs for UCCs from 0% to 10% would advance its primary objective as it considers a 0% CF for UCCs to be imprudent given the non-zero risk of UCCs coming on balance sheet.

3.55 The PRA considers that the proposals set out in this section should facilitate effective competition, particularly as a result of the proposed revised definition of commitment. This is because the PRA has an existing expectation that firms currently using the AIRB approach need only recognise an exposure once a customer can drawdown the facility. By withdrawing this expectation and proposing a new definition of commitment based on the contractual obligation, the PRA would bring firms applying the AIRB approach more in line with firms applying the SA or the FIRB approach. As a result, the introduction of a common definition of commitment across the SA and the IRB approaches is expected to remove an existing competitive advantage for firms that use the AIRB approach.

'Have regards' analysis

3.56 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Sustainable growth (FSMA regulatory principles) and growth (HMT recommendation letters):

- The PRA does not expect the proposals in this section to adversely impact sustainable growth. The proposed higher CFs for other commitments, other transaction-related contingent items, and UCCs are likely to increase RWAs for these items. However, the PRA considers this to be justified in order to help ensure adequate risk capture. If RWAs do increase, this may benefit sustainable growth to the extent that RWAs are currently too low. This is because the PRA considers that applying RWAs that adequately reflect risk is essential for sustainable lending and, therefore, sustainable growth.

2. Competitiveness (HMT recommendation letters) and relative standing of the UK as a place to operate (FSMA CRR rules):

- The PRA expects other jurisdictions to apply broadly similar CFs for off-balance sheet items and, therefore, the proposals should not adversely impact competitiveness. The proposal to apply a CF for other commitments that is somewhat higher than that set out in the Basel 3.1 standards could potentially impact the relative standing of the UK. This is because the commitments to which the other commitments CF would be applied include wholesale commitments, which are typically international in nature. The PRA considers that the potential impact on relative standing is justified from a safety and soundness perspective. The PRA also notes that it expects other jurisdictions, for example the EU (based on the European Commission's proposals), to apply a 50% CF for 'transaction-related contingent items' in line with the Basel 3.1 standards.

3. Relevant international standards (FSMA CRR rules):

- The PRA considers its proposals to be broadly aligned with the Basel 3.1 standards. While the PRA proposes a CF for other commitments that is higher than that set out in the Basel 3.1 standards, the PRA considers that this aligns with international standards because the Basel 3.1 standards envisage that national supervisors may choose to set stricter requirements.

4. Finance for the real economy (FSMA CRR rules):

- The PRA considers that the proposed changes in CFs for other commitments and other transaction-related contingent items may have some impact on certain business lines. For transaction-related contingent items, there is a risk that the increase in CFs may impact firms' willingness to provide these facilities which, in turn, may impact economic activity. For other commitments, the proposed CF would result in an increase in RWAs for short-term commitments under the SA and a reduction in RWAs for credit lines under the FIRB approach.

Exposures to central governments and central banks, regional governments and local authorities, public sector entities (PSEs), and multilateral development banks (MDBs)

3.57 This section sets out the PRA's proposals for implementing the Basel 3.1 standards for the SA to credit risk for exposures to 'central governments and central banks, regional governments and local authorities, public sector entities (PSEs), and multilateral development banks (MDBs)'.

Exposures to central governments and central banks, regional governments and local authorities, and PSEs

3.58 The Basel 3.1 standards do not introduce material changes to the existing Basel standards for risk-weighting exposures to central governments and central banks, regional governments and local authorities, and PSEs, although there are some structural changes in how the risk weights are presented. Risk weights in the Basel 3.1 standards are generally based on external ratings where available; however, some risk weight 'overrides', which typically result in lower risk weights being applied, are permitted at national discretion subject to certain conditions being met.

3.59 The CRR broadly aligns with the Basel 3.1 standards for risk-weighting exposures to UK central governments and central banks, regional governments and local authorities, and PSEs that are denominated and funded in Pound Sterling (GBP). The risk weights for third-country exposures to these counterparties are also generally determined by external ratings. However, a preferential treatment for third-country exposures is available in certain circumstances, based partly on an equivalence assessment of each third-country's banking regulation, which is determined by HMT. This preferential treatment broadly aligns with the national discretion permitted within the Basel 3.1 standards to override risk weights that are based on external ratings. For PSEs, the CRR equivalence assessment determines whether a ratings based approach can be used instead of a flat 100% risk weight.

3.60 HMT does not intend to revoke the relevant CRR sub-articles that contain the equivalence-related tests for central governments and central banks (Article 114(7)), regional governments and local authorities (Article 115(4)), and PSEs (Article 116(5)). Therefore, the equivalence-related sub-articles, including the parts relating to both the equivalence assessment itself and the risk weight treatment for exposures in jurisdictions that are deemed equivalent, would remain in the CRR.

3.61 The PRA understands that HMT intends to transfer the remaining parts of CRR Articles 114, 115, and 116 to the PRA. The PRA does not propose any substantive policy changes to these sub-articles.[12]

3.62 The PRA, however, proposes not to maintain the option in CRR Article 116(4) to treat exposures to UK PSEs as exposures to the central government, regional government or local authority of the UK where, in the PRA's opinion, there is no difference in risk between such exposures because of the existence of an appropriate guarantee by the central government, regional government, or local authority. The PRA does not currently identify any such exposures, as it considers UK PSE exposures to not be of the same risk as central government, regional government, or local authority exposures. Therefore, the proposal not to maintain this option would result in no change to risk weight treatments.

3.63 The PRA also proposes that sub-paragraph 2 of CRR Article 115 is amended to only capture the UK's devolved administrations. This maintains the PRA's view that the UK's devolved administrations are the only regional governments or local authorities that should be treated as exposures to the UK central government.

3.64 The PRA has concerns that the proposed SA risk weights for exposures to central governments, central banks, regional governments, and local authorities can potentially result in an underestimation of RWAs. Such undercapitalisation can stem from the 0% risk weight applied to highly rated central government and central bank exposures and the equivalence-based risk weight overrides.

3.65 The PRA currently has a Pillar 2A methodology for central government and central bank exposures that are risk-weighted under the SA. The methodology is based on IRB benchmark risk weights and is designed to address the potential undercapitalisation of risk arising from the SA. The PRA's proposal in this CP to remove the IRB modelling of central government and central bank exposures (see Chapter 4) would mean this benchmark cannot be updated in future as there would be no IRB risk weights on which to base the benchmark. The PRA's existing Pillar 2A methodology also does not cover regional governments and local authorities. The PRA, therefore, intends to consult in the future, as part of the wider Pillar 2 review discussed in Chapter 10 – Interactions with the PRA's Pillar 2 framework, on a potential Pillar 2 methodology to help ensure the adequate capitalisation of these exposures.

3.66 The PRA also intends to consider whether it would be appropriate to consult on any changes to the treatment of these exposures under the large exposures regime.

Exposures to multilateral development banks (MDBs)

3.67 The PRA proposes to introduce a definition of MDBs which clarifies the scope of MDB exposures.

3.68 The PRA proposes to retain the CRR list[13] of MDBs that are eligible for a 0% risk weight. The PRA also proposes to maintain the CRR approach that the Inter-American Investment Corporation, the Black Sea Trade and Development Bank, the Central American

Bank for Economic Integration, and the CAF-Development Bank of Latin America shall be considered MDBs.

3.69 The PRA proposes a change to the treatment of MDBs that are not eligible for a 0% risk weight to align with the Basel 3.1 standards. Under the CRR, exposures to MDBs that are not assigned a risk weight of 0% are treated in the same manner as exposures to institutions. Unrated MDBs are risk-weighted based on the external rating of the sovereign.

3.70 The PRA proposes that externally rated MDB exposures that are not eligible for a 0% risk weight would be classified as 'exposures to other MDBs' and that their risk weights would be determined by the applicable CQS.[14] For exposures to all other MDBs that are unrated, the PRA proposes to apply a flat risk weight of 50% in order to align with the Basel 3.1 standards.

> **Question 6: Do you have any comments on the PRA's proposed approach to exposures to central governments and central banks, regional governments and local authorities, PSEs, and MDBs?**

PRA objectives analysis

3.71 The PRA proposes to maintain the existing approach (in substantive terms) under the CRR for exposures to central governments and central banks, regional governments, and local authorities in order to advance the PRA's primary objective.

3.72 The PRA's proposals for MDBs support the PRA's primary objective as the changes should maintain risk-sensitivity in RWAs as risk weights would be based on external ratings where available. While the proposed flat 50% for unrated MDBs could reduce RWAs for riskier MDB exposures, the PRA does not expect the impact to be material.

3.73 By broadly aligning with the Basel 3.1 standards, the PRA considers that the proposals set out in this chapter are consistent with its secondary competition objective as all firms using the SA would be subject to consistent requirements. As set out in Chapter 4, the PRA also proposes to require all central government and central bank exposures to be risk-weighted under the SA and, therefore, prohibit modelling of these exposures under the IRB approach. This should improve competition between firms using the SA and firms with IRB permissions.

'Have regards' analysis

3.74 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA),

the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Competitiveness (HMT recommendation letters) and relative standing of the UK as a place to operate (FSMA CRR rules):

- The PRA expects other jurisdictions to apply broadly similar requirements to exposures to central governments banks and central banks, regional governments and local authorities, PSEs, and MDBs. As a result, the proposals set out in this section should support the competitiveness of the UK. The European Commission proposes to maintain the status quo position in the CRR.

2. Relevant international standards (FSMA CRR rules):

- The PRA considers that its proposals would be broadly aligned with the Basel 3.1 standards, so the proposed changes should help ensure that the UK meets international standards. For PSEs, the PRA proposes not to treat any exposures to UK PSEs as exposures to the UK central government, a regional government, or a local authority in the UK. This aligns with the Basel 3.1 standards, as the PRA proposes to not implement the Basel 3.1 national discretion to treat PSEs as exposures to the sovereign in certain circumstances.

3. Finance for the real economy (FSMA CRR rules):

- The PRA considers that the proposals should have no adverse impacts on the provision of finance for the economy as they broadly maintain the existing approach. The PRA proposes changes to the treatment of MDBs but does not consider these changes to have adverse impacts on the provision of finance for the economy.

Exposures to institutions and covered bonds

3.75 This section sets out the PRA's proposed changes to the SA to credit risk for exposures to 'institutions' and 'covered bonds'.

Exposures to institutions

Rated institutions

3.76 The PRA proposes to retain the CRR external credit rating approach (ECRA) for institutions. Under this approach, exposures to institutions are assigned a risk weight according to the CQS. The PRA also proposes to continue to permit a more favourable treatment for exposures to institutions that are short-term exposures.

3.77 The PRA proposes to introduce a new requirement that aligns with the Basel 3.1 standards, such that external credit ratings used for regulatory purposes should not incorporate assumptions of implicit government support, unless the rating refers to an institution owned by or set up and sponsored by its central government, regional government, or local authority.

3.78 The PRA proposes to maintain the same risk weights for rated institutions (including for short-term exposures) as in the CRR, with the exception of a lower risk weight for exposures to institutions in CQS 2 (a 30% risk weight compared to a 50% risk weight under the CRR) in order to introduce greater risk-sensitivity. This aligns with the Basel 3.1 standards.

Table 1: Overview of the proposed SA risk weights for exposures to rated institutions

Risk weights for externally rated exposures to institutions					
Credit quality step	**1**	**2**	**3**	**4-5**	**6**
Risk weight	20%	30%	50%	100%	150%
Short-term exposures					
Risk weight	20%	20%	20%	50%	150%

3.79 The PRA also proposes to make the following changes to the SA treatment for exposures to institutions:

- to base maturity on original maturity rather than residual maturity for determining short-term exposures;
- to allow exposures to institutions to receive risk weights for short-term exposures, where the original maturity of the exposure is six months or less and the exposure arose from the movement of goods across national borders;
- to require firms to conduct due diligence. If a firm’s due diligence analysis identifies higher risk characteristics than implied by a counterparty’s external rating(s), the firm would be required to assign the exposure to a CQS at least one higher than determined by the external rating. Proposed requirements for undertaking due diligence are covered in the ‘External credit ratings and due diligence’ section of this chapter;
- to not maintain the CRR provision[15] that exposures to institutions of a residual maturity of three months or less that are denominated and funded in the national currency of the borrower shall be assigned a risk weight that is one category less favourable than the

preferential risk weight assigned to exposures to the central government in the jurisdiction that the institution is incorporated; and

- to not maintain the CRR provision[16] that no exposures with a residual maturity of three months or less that are denominated and funded in the national currency of the borrower shall be assigned a risk weight less than 20%.

Unrated institutions

3.80 For exposures to an institution for which an external credit rating is not available (an 'unrated institution'), the PRA proposes to introduce a new approach: the standardised credit risk assessment approach (SCRA). Under this approach, institutions are categorised into one of three grades (A, B, or C) depending on the institution's ability to meet or exceed published minimum regulatory requirements,[17] and the firm's internal assessment of the credit risk of the counterparty. The exposure is then assigned a risk weight depending on the grade, which in turn reflects its riskiness (see Table 2 below). The proposed treatment for exposures to unrated institutions removes the link between the risk-weighting of institutions and their sovereigns.

3.81 The PRA proposes that the SCRA would include a general preferential treatment for short-term exposures to unrated institutions, but one which is less preferential than under the CRR. The CRR currently applies a risk weight of 20% for exposures with an effective original maturity of three months or less, whereas under the SCRA the proposed risk weight applied to these exposures would be 20% for Grade A, 50% for Grade B, or 150% for Grade C.

Table 2: Overview of the proposed SA risk weights for exposures to unrated institutions

Risk weights for unrated exposures to institutions			
Credit quality step	**Grade A**	**Grade B**	**Grade C**
Risk weight	40%[18]	75%	150%
Short-term exposure	20%	50%	150%

3.82 The PRA also proposes to make the following changes to the SA treatment for exposures to unrated institutions:

- to allow exposures to unrated institutions to receive risk weights for short-term exposures, where the original maturity of the exposure is six months or less and the exposure arose from the movement of goods across national borders; and

- to require that risk weights assigned to unrated institutions may not be less than the risk weight applicable to sovereign exposures in the jurisdiction where the unrated institution is incorporated, subject to certain conditions.[19]

Treatment of covered bonds

3.83 The PRA proposes to make two changes to the CRR treatment of covered bonds impacting: (i) the risk weight treatment for unrated covered bonds; and (ii) the application of due diligence requirements. These proposed changes align with the Basel 3.1 standards on the treatment of covered bonds under the SA.

The risk weight treatment for unrated covered bonds

3.84 Both the CRR and the Basel 3.1 standards base the risk weights for unrated covered bonds, in cases where the covered bonds meet the requirements for preferential treatment, on the risk weights that would apply to an exposure to the issuing institution. Consistent with the Basel 3.1 standards, the PRA proposes to introduce changes to risk weights for unrated covered bonds through a more risk-sensitive mapping from the issuing institution's risk weight to the unrated covered bond risk weight. This is consistent with the proposal for the treatment of institutions, and the risk weight depends on whether the issuing institution is rated or not (as set out in the tables below). The PRA proposes that the risk weight for unrated covered bonds issued by rated institutions in CQS 2 is reduced from 20% to 15%, and that the risk weight for unrated covered bonds issued by rated institutions in CQS 3 is increased from 20% to 25%. The PRA considers this would introduce greater risk-sensitivity that aligns with the proposed ECRA and SCRA treatment for exposures to institutions.

Table 3: Proposed risk weights for exposures to unrated covered bonds (issuing institution: rated)

Risk weights for exposures to unrated covered bonds					
Credit quality step of issuing institution (rated institution)	**1**	**2**	**3**	**4 and 5**	**6**
PRA proposed risk weight for the issuing institution	20%	30%	50%	100%	150%
PRA proposed risk weight for exposures to unrated covered bonds	10%	15%	25%	50%	100%

Table 4: Proposed risk weights for exposures to unrated covered bonds (issuing institution: unrated)

Risk weights for exposures to unrated covered bonds			
Credit quality step of issuing institution (unrated institution)	**A**[20]	**B**	**C**
PRA proposed risk weight for the issuing institution	40%	75%	150%
PRA proposed risk weight for exposures to unrated covered bonds	20%	35%	100%

3.85 The PRA does not expect that the proposed risk weights for unrated covered bond exposures would have a material impact as SA firms' unrated covered bond exposures are not material. Firms' implementation costs would likely be small as the change relates purely to the assignment of exposures to CQS.

3.86 The PRA also proposes to clarify in a rule that the obligation to meet certain credit risk mitigation (CRM) requirements relating to immovable property collateralising covered bonds are only applicable where a firm is seeking to apply the preferential SA risk weight treatment for covered bonds. The PRA also proposes minor changes to the relevant CRM requirements themselves, which are set out in Chapter 5 – Credit risk mitigation.

Due diligence requirement for covered bonds

3.87 The PRA proposes to introduce new requirements under the SA that are designed to reduce firms' mechanistic use of external credit ratings for risk-weighting covered bond exposures. The PRA proposes that firms should perform due diligence on covered bond exposures, in accordance with the 'External credit ratings and due diligence' section in this chapter. If a firm's due diligence analysis identifies higher risk characteristics of an exposure than implied by a counterparty's external rating(s), the firm would be required to assign the exposure to a CQS at least one higher than determined by the external rating.

> **Question 7: Do you have any comments on the PRA's proposed changes to ECRA, the proposed introduction of SCRA for exposures to unrated institutions, and the proposed treatment of covered bonds?**

PRA objectives analysis

3.88 The PRA considers its proposals in this section to further its primary objective of promoting safety and soundness. The proposed introduction of the SCRA removes the reliance on sovereign ratings when risk-weighting unrated institution exposures, removing an implicit assumption of government support. Instead, firms would be required to assess the direct credit risk of exposures to institutions. This should help ensure that risk weights better reflect the risk of the counterparty itself. Additionally, the introduction of new due diligence requirements for exposures to institutions and covered bonds should reduce the risk of firms mechanistically relying on external credit ratings and should help ensure risk weights more accurately reflect the actual risk of the exposures.

3.89 The PRA considers its proposals for exposures to institutions to facilitate its secondary competition objective. Increased risk-sensitivity in the SA risk weights for institutions may improve competition between SA and IRB firms to the extent that the SA firms would benefit from lower risk weights for lower risk exposures. The PRA considers its proposals for covered bonds would have limited impact on competition.

'Have regards' analysis

3.90 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Efficient and economic use of PRA resources (FSMA regulatory principles):

- The PRA expects the SCRA would increase the operational burden on firms relative to the existing approach in the CRR. That means supervisory resource may be required to help ensure that firms are conducting assessments correctly. The PRA does not expect this would be material as firms using the SA have limited exposures to unrated institutions. Costs to the PRA are estimated to be outweighed by safety and soundness benefits as the risk weights should better capture risk. The PRA does not expect the proposed risk weight treatment for covered bonds to have a significant impact on PRA resources.

2. Proportionality (FSMA regulatory principles and Legislative and Regulatory Reform Act 2006):

- The PRA considers the proposals in this section to be proportionate. Where the PRA proposes measures that would increase RWAs, it considers this to be justified as it expects the revised requirements to better reflect the risks faced by firms.

3. Sustainable growth (FSMA regulatory principles) and growth (HMT recommendation letters):

- The PRA considers the proposals set out in this section would be unlikely to have a material impact on firms' RWAs or balance sheet structures. The proposals should help to ensure that firms are able to continue lending and, therefore, support growth in the economy throughout the economic cycle, and that firms can be successfully resolved, if necessary, without significant disruption to the wider economy.

4. Competitiveness (HMT recommendation letters) and relative standing of the UK as a place to operate (FSMA CRR rules):

- The PRA considers that its proposals for exposures to institutions would not have a significant impact on the relative standing of the UK. The PRA expects other major jurisdictions to adopt the same reforms, in line with the Basel 3.1 standards. There may be instances of jurisdiction-specific adjustments (such as in the European Commission's proposals)[21] that result in some of the PRA's proposals being more conservative than in other jurisdictions. For example, the PRA's proposal for short-term exposures to Grade C unrated institutions is more conservative than the European Commission's proposal. However, the PRA's proposals are aligned with Basel 3.1 standards and the PRA expects firms' exposures to Grade C unrated institutions to be small so any difference in approach should have limited impact.

5. Relevant international standards (FSMA CRR rules):

- By implementing the reforms in the Basel 3.1 standards for exposures to institutions faithfully, and by removing existing deviations from the Basel standards in the CRR, the proposed changes would help to ensure that the UK meets international standards. The PRA's proposal to apply due diligence requirements to covered bonds aligns with international standards and the PRA considers it be justified on safety and soundness grounds.

Exposures to corporates and specialised lending

3.91 This section sets out the PRA's proposals for the treatment of 'corporate' and 'specialised lending' exposures under the SA to credit risk.

3.92 The PRA proposes to enhance the risk-sensitivity of the SA for calculating RWAs for corporate exposures. It seeks to achieve this by utilising the risk-sensitive ECRA approach where corporates are rated, by introducing greater risk-sensitivity for risk-weighting corporate exposures that are not rated, and by introducing a specific treatment for specialised lending exposures. The PRA also proposes some additional minor changes.

Corporate exposures

Approach to externally rated corporate exposures

3.93 The PRA proposes to continue to allow the use of external credit ratings for determining the RWAs applied to corporate exposures. The PRA also proposes to enhance risk-sensitivity by reducing the risk weight applicable to counterparties assigned to CQS 3 from 100% under the CRR to 75%. This proposal aligns with the Basel 3.1 standards, and continues to produce a risk-sensitive outcome where credit ratings are available. While the PRA does not propose changes to the risk weight treatment for exposures to corporates with a short-term credit rating, these existing requirements would be moved into Article 122 of the Credit Risk: Standardised Approach (CRR) Part for further clarity.

Table 5: Proposed risk weights for externally rated corporate exposures

CQS 1	CQS 2	CQS 3	CQS 4	CQS 5-6
Proposed treatment for externally rated corporates				
20%	50%	75%	100%	150%
CRR treatment for externally rated corporates				
20%	50%	100%	100%	150%

3.94 As set out in the ‘External credit ratings and due diligence’ section, the PRA proposes to require firms to conduct due diligence on their corporate exposures. If a firm’s due diligence analysis identifies higher risk characteristics of an exposure than implied by its external rating(s), the firm would be required to assign the exposure to a CQS at least one higher than determined by the external rating.

Approach to unrated corporate exposures

3.95 The PRA proposes to permit two possible approaches to risk-weighting unrated corporate exposures: (i) a risk-sensitive approach that would be available where a firm has sound, effective and comprehensive strategies, systems and due diligence processes to accurately assess the risk of unrated corporate exposures, and (ii) a risk-neutral approach of a 100% risk weight where the risk-sensitive approach is too costly or complex for a firm to implement, or the firm lacks the capability to robustly assess the risk of unrated corporate exposures.

3.96 The PRA considers that the risk-sensitive approach would allow firms to distinguish, according to their internal credit rating systems, between ‘investment grade’ (IG) and ‘non-investment grade’ (Non-IG) unrated corporate exposures (including for direct credit exposures to unrated corporates and counterparty credit risk exposures to counterparties including funds).

3.97 The PRA proposes that under the risk-sensitive approach, exposures assessed by firms as IG would be risk-weighted at 65%, while exposures assessed by firms as Non-IG would be risk-weighted at 135%. The proposal aims to increase risk-sensitivity in the framework and better reflect the underlying risk of different unrated corporate exposures, while seeking to maintain an aggregate level of RWAs which is broadly consistent with that calibrated under the Basel 3.1 standards. That is, it is anchored around an average risk weight of 100% according to the PRA’s analysis of available firm data.[22]

3.98 Firms would be required to apply a consistent approach to risk-weighting all unrated corporate exposures meaning firms would either apply a 100% risk weight to all unrated corporate exposures, or would apply the risk-sensitive approach to all unrated exposures and assign a 65% or 135% risk weight depending on whether the exposure was IG or Non-IG.

3.99 The PRA proposes that a corporate entity should be deemed to be IG if it has adequate capacity to meet its financial commitments in a timely manner and that its ability to do so should be robust against adverse changes in the economic cycle and business conditions. Firms would be required to take into account the complexity of the corporate entity’s business model, performance against industry and peers, and risks posed by the entity’s operating environment. A corporate entity would not need to have securities outstanding on a recognised exchange to be assessed as IG. However, firms would need to have sufficient information to conduct adequate due diligence for the assessment of whether the corporate entity is IG. The PRA proposes to introduce an expectation that a firm’s determination of whether a counterparty is IG should broadly reflect a similar level of creditworthiness and risk as an exposure that has an external rating that would map to CQS 1, 2 or 3.

3.100 For unrated corporates that are classified as ‘corporate SMEs’, an 85% risk weight would apply as set out in the ‘Exposures to individuals and small and medium-sized enterprises’ section. Therefore, the two options above would not be available.

3.101 The PRA recognises that this proposal is a particularly important element of the package given the range of unrated corporate exposures held by firms. It is, therefore, important that the risk-sensitive approach is calibrated to apply appropriate risk weights to IG and Non-IG exposures. As set out in the ‘have regards’ analysis below, the PRA has used the data it has available to develop a proposal that it considers would in aggregate achieve a similar outcome to the Basel 3.1 standards, while introducing risk-sensitivity and allowing firms to benefit from a lower risk weight for IG unrated corporate exposures. However, it would particularly welcome any additional empirical evidence that firms, both those currently using the SA and those using the IRB approach, can provide in respect of the appropriateness of the proposed calibration of risk weights for both IG and Non-IG unrated corporate exposures.

3.102 The PRA proposes that the risk-sensitive approach can only be used by a firm using the SA where it has applied for permission and permission has been granted by the PRA. Permission to use the risk-sensitive approach would only be granted where a firm can evidence sound processes, systems, and due diligence practices for credit risk that enable it to adequately identify and manage credit and counterparty credit risk.

3.103 The risk-neutral approach of a flat 100% risk weight would be available to firms that choose not to apply for permission to use the risk-sensitive approach, or where the PRA deems that the conditions to grant permission are not met.

3.104 The PRA proposes that for the purposes of calculating the proposed output floor (see Chapter 9), a firm with an existing permission to use the IRB approach for the corporate exposure class may use either the risk-neutral approach (100% risk weight) or the risk-sensitive approach (65% or 135% risk weight) without having to apply for a separate permission. These firms would need to notify the PRA of the approach they choose to apply, notify the PRA if they change the approach they use, and apply the chosen approach consistently for all unrated corporate exposures.

3.105 Firms with IRB permission for risk-weighting the corporate exposure class may use their approved IRB model as one of the inputs to determine whether an unrated corporate entity should be deemed to be IG. However, the IRB model should not be the sole determinant of whether the exposure is IG and these firms would still be required to make the IG assessment based on the proposed definition of IG. The PRA notes that this is not intended to change the approach to modelling these exposures under IRB or the PRA's standards for IRB approval.

3.106 The PRA proposes to add expectations to the proposed SS10/13 – 'Credit risk: Standardised approach' regarding the proposed approach to the permission process and the identification of IG exposures.

Question 8: Do you have any comments on the PRA's proposed approach for exposures to unrated corporates? Do you have any evidence – quantitative or qualitative – to support your comments, particularly in respect of the proposed 135% risk-weight for Non-IG exposures?

Specialised lending exposures

3.107 The PRA proposes to introduce a definition of specialised lending exposures and to define sub-classes of specialised lending exposures (‘commodities finance’, ‘object finance’, and ‘project finance’) to more closely align the SA with the IRB approach.

3.108 Consistent with the Basel 3.1 standards, the PRA also proposes new risk weights for certain specialised lending exposures to increase risk-sensitivity. These are dependent on whether an issue-specific external rating is available.[23]

3.109 Where an issue-specific external rating is available, the PRA proposes that the risk weight should be determined by the issue-specific external rating (see Table 5 above for the proposed risk weights). If an issue-specific external rating is not available, the firm would risk-weight the specialised lending exposure based on the sub-class of the exposure: commodities finance, object finance, or project finance.

3.110 For object finance and commodities finance exposures that are unrated, the PRA proposes that a 100% risk weight should be assigned. The PRA considers that these risk weights reflect the broad universe of underlying assets with different risk profiles that could fit within the sub-classes of specialised lending exposures and, broadly, should help ensure an adequate level of RWAs relative to the risk.

3.111 For project finance exposures that are unrated, the PRA proposes to differentiate between exposures that are within a pre-operational versus operational phase. To be deemed to be in the operational phase, a project finance entity would have: a positive net cash flow covering all contractual obligations relating to the completion of the project, and declining long-term debt. If these criteria are not met, the exposure would be classified as being in the pre-operational phase. The PRA proposes that an unrated project finance exposure in the operational phase should be risk-weighted at 100% and an exposure that is in the pre-operational phase should be risk-weighted at 130%, reflecting the greater risk.

3.112 The PRA also proposes to introduce further risk-sensitivity for unrated project finance exposures that are in the operational phase and are considered ‘high-quality’. The criteria for being considered ‘high-quality’ include whether the exposure is to an entity that is able to meet its financial commitments in a timely manner and its ability to do so is assessed to be robust against adverse changes in the economic cycle and business conditions; and that conditions covering the entity’s revenue and creditor protection are satisfied. Where this is the case, the PRA proposes that the exposures should be risk-weighted at 80%.

Question 9: Do you have any comments on the PRA’s proposed approach for specialised lending exposures, or data that is relevant to this analysis?

CRR infrastructure support factor

3.113 The CRR infrastructure support factor allows firms to apply a 0.75 multiplier to RWAs for certain exposures that are allocated to the corporate exposure class or specialised lending exposure class. Defaulted exposures are excluded and the criteria in CRR Article 501a need to be satisfied. It applies to exposures under the SA and IRB approaches.

3.114 As noted above, the PRA proposes to apply a more risk-sensitive approach to project finance exposures – largely the same exposures to which the CRR infrastructure support factor may be applied. The more risk-sensitive approach includes a 20% lower risk weight – similar in magnitude to that of the infrastructure support factor – for 'high-quality' project finance exposures in the operational phase.

3.115 The PRA considers that, given the proposed project finance treatment includes a broadly similar discount to the infrastructure support factor, maintaining the support factor could result in an unjustified reduction in RWAs for qualifying exposures. It would result in a 'doubling-up' of risk weight concessions if firms apply both the preferential risk weights for high-quality project finance and the support factor. The PRA considers that the proposed project finance treatment would set reasonably lower but prudent risk weights for exposures to infrastructure projects and the proposed approach may in fact broaden the scope of the lower risk weight compared to the existing support factor. Therefore, the PRA proposes not to maintain the infrastructure support factor under the SA. However, the PRA has a relatively small evidence base for the calibration of risk weights in this area, including on the impact of the support factor on lending to infrastructure (partially because the support factor is relatively new), and considers it important to help ensure that it has a broad range of evidence on which to support its analysis. Therefore, it particularly invites firms to present quantitative or qualitative evidence on this topic during the consultation.

Question 10: Do you have any comments on the PRA's proposed removal of the infrastructure support factor? Do you have any evidence – quantitative or qualitative – to support your comments?

PRA objectives analysis

3.116 The PRA's overall proposals for corporate exposures aim to increase risk-sensitivity in the approach for rated and unrated corporate exposures. The PRA considers its proposal relating to unrated corporate exposures furthers the PRA's primary safety and soundness objective by introducing additional risk-sensitivity ie balancing lower risk weights for lower risk exposures with higher risk weights for higher risk exposures. The proposed introduction of a permission process to allow SA firms to apply the risk-sensitive approach for unrated corporates is intended to help ensure that only those firms that have adequate risk management capability to robustly distinguish between IG and Non-IG exposures would be permitted to use the approach. This should help ensure it is applied prudently.

3.117 The PRA considers that the proposal to introduce new definitions and risk weights for specialised lending advances its primary objective of safety and soundness through enhanced risk-sensitivity, and that the proposed risk weights should be broadly reflective of the relative risks across different specialised lending categories. The proposal to remove the infrastructure support factor would also advance the PRA's primary objective given that the PRA considers the proposed approach for project finance exposures is more risk-sensitive, and removing the support factor avoids an unwarranted double-discount on RWAs.

3.118 The PRA considers that the proposals regarding corporate exposures support the PRA's secondary competition objective of facilitating effective competition. The proposals would provide all SA firms the possibility of risk-weighting rated and unrated corporate exposures using the same method, and the same approaches would be available to SA firms and firms with IRB permissions using SA for the purpose of calculating the proposed output floor. The risk-neutral proposal for unrated corporate risk weights would provide a simple low-cost method for firms where assessing the IG and Non-IG distinction is deemed too complex and costly.

3.119 The proposals to introduce new definitions relating to specialised lending should also facilitate effective competition by achieving greater consistency in approach between firms using the SA and those using the IRB approach to calculate RWAs.

'Have regards' analysis

3.120 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Relevant international standards (FSMA CRR rules):

- The proposal for rated corporate exposures would align with the Basel 3.1 standards for corporate exposures where an external credit rating is available.
- For unrated corporate exposures, the Basel 3.1 standards require that jurisdictions that allow the use of external credit ratings for regulatory purposes (as proposed by the PRA) should require firms to risk-weight unrated corporate exposures at 100%. The PRA's proposed approach for unrated corporate exposures aims to maintain a broadly similar overall level of resilience to the 100% risk weight in the Basel 3.1 standards (based on data submitted to the PRA and public information) while increasing risk-sensitivity. The consistency between the PRA's proposed calibration and the calibration in the Basel 3.1

standards at an aggregate level would depend on how many SA firms are granted permission by the PRA to use the risk-sensitive approach, and the split between IG and Non-IG exposures in those firms' portfolios.

- The proposal to not maintain the infrastructure support factor would align the PRA with the Basel 3.1 standards. The PRA expects and understands that most other jurisdictions would also align with the Basel 3.1 standards as they do not have an infrastructure support factor.
- All other proposals in this section align with the Basel 3.1 standards.

2. Relative standing of the UK as a place to operate (FSMA CRR rules) and competitiveness (HMT recommendation letters):

- The PRA considers that its proposals support the competitiveness of UK firms in lending to rated corporates. The proposal for rated corporate exposures aligns with international standards for jurisdictions that allow the use of external credit ratings for regulatory purposes, and, therefore, should support the relative standing of the UK. The proposed risk weights assigned to some rated corporate exposures may be lower than those in jurisdictions that do not allow the use of external credit ratings for regulatory purposes (eg the USA) given that the Basel 3.1 standards apply a minimum 65% risk weight in such cases (if identified as IG). It is also the case that the proposed risk weights assigned to some rated corporate exposures may be higher than those in jurisdictions that do not allow the use of external credit ratings for regulatory purposes, particularly if the corporate is mapped to CQS 3 or above.
- For unrated corporates, the PRA's risk-sensitive proposal for IG exposures would support the UK's relative standing as it applies a similar risk weight as being proposed in some other jurisdictions for unrated corporate exposures that are assessed as IG. However, the PRA acknowledges that where a firm uses the risk-sensitive approach for Non-IG exposures, it would apply a higher risk weight for these exposures than in some other jurisdictions, for example, in the EU, based on the European Commission's proposals,[24] and a lower risk weight than in others, for example Canada, based on the Office of the Superintendent of Financial Institutions' (OSFI's) policy.[25]
- While there may be instances of jurisdiction-specific adjustments (such as the European Commission's proposals), the PRA's proposals for specialised lending should be broadly consistent with the likely approach of most other jurisdictions, which would support the relative standing of the UK. The UK treatment of specialised lending may be more conservative, but the PRA considers that this is necessary for safety and soundness.

3. Different business models (FSMA regulatory principles):

- The PRA acknowledges that where firms apply the risk-sensitive approach to risk-weighting unrated corporate exposures, the proposal is likely to have a greater impact on firms with material lending to Non-IG unrated corporates. This is because they would apply a 135% risk weight to such exposures instead of the 100% risk weight in the Basel 3.1 standards. However, firms have the option to apply the risk-neutral approach, which applies a 100% risk weight, instead of seeking to use the risk-sensitive approach. Also, it is likely that firms that apply for permission to use the risk-sensitive approach would incur operational costs. However, the optionality in the possible approaches should allow firms to select an approach that they deem to be most appropriate for their business model, subject to obtaining permission from the PRA.

4. Climate change (FSMA CRR rules, HMT recommendation letters):

- The PRA considers that the climate change considerations are nuanced and complex for the specialised lending proposals. The proposal for object finance does not distinguish between high or low emission objects and, therefore, while there would be no preferential treatment for exposures that directly contribute to net zero emissions, there would also be no active encouragement of lending to high emission object finance. The proposal for project finance should capture financing of environmental infrastructure projects, and the PRA considers that the proposed approach may apply to a wider range of exposures than covered by the CRR infrastructure support factor. Therefore, the project finance proposal could make a positive contribution towards the net zero emissions target.

5. Finance for the real economy (FSMA CRR rules):

- The PRA considers that for unrated corporates that primarily seek finance from firms that use the SA, the impact of the proposals on finance for the economy would depend both on: (i) the credit quality of the corporate itself; and (ii) whether the firm uses the risk-neutral (100% risk weight) or risk-sensitive (65% or 135% risk weight) approach. If the firm uses the proposed risk-sensitive approach, risk weights for IG unrated corporates would reduce compared to the position under the CRR while risk weights for Non-IG unrated corporates would increase. This could potentially increase the provision of finance by SA firms to lower-risk unrated corporates and decrease the provision of finance to higher-risk unrated corporates. There would be no change to the existing position in respect of firms that use the 100% risk weight for all unrated corporate exposures.
- For firms with IRB permissions applying the SA risk weights for the purpose of the proposed output floor, the impact of the PRA's proposals on risk weights, and the potential impact on finance for the economy, would depend on how the SA risk weights compare to the firm's modelled risk weight for any given unrated corporate exposure, and whether the output floor is binding on an aggregate RWA basis (see Chapter 9). For very low-risk unrated corporate exposures, the PRA expects the proposed 65% or 100% SA risk weights would often be higher than modelled risk weights. For very high-risk unrated corporate exposures, the PRA expects that the proposed 100% or 135% SA risk weights

would often be lower than modelled risk weights. The aggregate impact on RWAs would depend on whether a firm has more exposure to relatively lower- or higher-risk unrated corporate exposures. The provision of finance to any specific unrated corporate could, however, be impacted. For unrated corporate exposures around the IG/Non-IG boundary, the difference between the SA risk weights under the risk-sensitive approach and modelled risk weights is likely to be case-specific with the SA risk weights being higher than modelled risk weights for some exposures and lower for others.

- Overall, while the PRA considers that there is some potential for its proposals to impact finance to the economy, it expects the impact at the system-wide level would be relatively limited. The impact of the PRA's proposal would likely vary across corporates of different levels of risk, depending on the relative conservatism of the PRA's proposed risk weights compared to existing SA or IRB risk weights for any specific exposure.
- The PRA also considers that the impact of changes in RWAs on lending to corporates is nuanced and that there is not a direct relationship between RWAs and lending decisions. The provision of finance to mid-market unrated corporates is also dependent on other factors such as relationships, locality, and sector-expertise, which influence borrower and lender decisions and create competitive advantages separate to the impact of the regulatory capital regime.

Exposures to individuals and small and medium-sized enterprises

3.121 This section sets out the PRA's proposed changes to the SA to credit risk for lending to individuals and small businesses. This section is split into three parts:

- exposures to small and medium-sized enterprises (SMEs);
- the SA treatment of 'regulatory retail' exposures (excluding real estate); and
- the SA treatment for 'retail' exposures with currency mismatch.

Exposures to SMEs

3.122 The PRA proposes changes to the treatment of exposures to SMEs, reflecting the Basel 3.1 standards, including the introduction of a new 'corporate SME' exposure sub-class and the introduction of a new risk weight treatment for regulatory retail exposures. The PRA proposes to not maintain the CRR SME support factor under both the SA and IRB approaches for credit risk (see Chapter 4). In turn, the PRA proposes to maintain the lower CRR risk weight for retail SME exposures and to introduce a new lower risk weight for unrated corporate SME exposures to align with the Basel 3.1 standards.

CRR SME support factor

3.123 The CRR SME support factor was originally introduced to limit disruption to the flow of credit to small businesses during the phase-in of stricter requirements following the 2008 global financial crisis. For exposures to businesses with a turnover below €50 million and total amount owed to the institution (excluding residential property) not exceeding €1.5 million, a support factor equal to 0.7619 could be applied to RWAs. This calibration was designed to broadly offset the additional capital required for the capital conservation buffer.

3.124 The SME support factor applies to all credit risk exposures included in the retail, corporates, or 'secured by mortgages on immovable property' exposure classes which satisfy a set of criteria (exposures in default are excluded). It applies to the SA and IRB approaches and was identified as a material deviation from the Basel standards in the 2014 BCBS Regulatory Consistency Assessment Programme (RCAP) assessment of the EU CRR.[26]

3.125 CRR II[27] expanded the scope of the SME support factor. The ceiling on total amount owed to the institution (excluding residential property) was raised to €2.5 million, and a new discount rate of 15% was made available in connection to any lending exceeding this threshold. These changes were nationalised into the CRR when the UK left the EU.

3.126 The CRR also allows certain qualifying SME exposures[28] to be risk-weighted as retail exposures, with a risk weight of 75% applied instead of the 100% risk weight applied to other unrated corporates. The PRA proposes to retain the existing lower 75% risk weight. This means there is currently a 'doubling-up' of preferential risk weights between the SME support factor, which is applied to exposures after they have been risk-weighted, and the existing lower risk weights in the CRR for SMEs. For example, firms can apply an SA risk weight as low as 57% to certain SME exposures by applying the SME support factor to the 75% risk weight for retail-qualifying SME lending. The PRA considers this to be imprudent and not risk-sensitive.

3.127 As noted in paragraph 3.133 below, the PRA proposes to implement a new risk weight treatment for unrated corporate SMEs[29] that is included in the Basel 3.1 standards. This would result in a lower risk weight of 85% for corporate SME exposures that do not qualify for the retail class. Given that this new discounted risk weight would apply to the same exposures as the SME support factor, maintaining the SME support factor would cause a 'doubling-up' effect for these exposures, which the PRA considers would result in imprudent risk weights.

3.128 The PRA also proposes to implement a new approach for 'transactor exposures' (discussed further in the 'Transactors, non-transactors and other retail exposures' part of this section) in the regulatory retail exposure class whereby a preferential risk weight treatment of 45% would be applied. Maintaining the SME support factor and introducing this new preferential risk weight would also cause a ‘doubling-up’ effect for these exposures, resulting in risk weights for unsecured SME lending as low as 34%, which the PRA considers imprudent.

3.129 The PRA has considered existing analysis on the effectiveness of the SME support factor, and while the PRA recognises conceptually the SME support factor could be a stimulus for supporting sustainable lending to SMEs, it considers the available evidence is mixed and inconclusive at a system level. For example, the European Banking Authority (EBA) analysis found that there was no conclusive evidence that the SME support factor provided additional stimulus for lending to SMEs compared to large corporates.[30]

3.130 On balance, the PRA is of the view that retaining the SME support factor could be inconsistent with the PRA’s primary objective, and, therefore, proposes to remove it under the SA. When combined with the lower SA risk weights for SME exposures, it would result in RWAs that do not adequately reflect the risk of the exposures, which the PRA considers could pose a threat to the safety and soundness of firms.

3.131 Given the new risk weights the PRA proposes to introduce for corporate SME exposures and ‘retail transactor’ exposures, the combined impact of the proposals would likely be to increase RWAs for some SME exposures and reduce them for other SME exposures. The impact on any given firm would depend on its lending mix.

3.132 The non-capital benefits of removing the SME support factor are also relevant to the PRA’s proposal. Removing the existing ‘mixing and matching’ between the BCBS and CRR risk weights would result in a simpler and more transparent approach for determining RWAs for SME exposures. Firms are currently required to calculate a support factor for individual SME counterparties that can vary over time depending on lending mix, exposure amounts, and amortisation profiles. The PRA considers the existing CRR approach unnecessarily complex and increases the risk of firms miscalculating RWAs.

> **Question 11: Do you have any comments on the PRA’s proposed removal of the SME support factor? Do you have any evidence – quantitative or qualitative – to support your comments?**

Corporate SMEs

3.133 The PRA proposes introducing a new treatment for unrated corporate SME exposures.[31] Exposures to unrated corporate SMEs would receive a risk weight of 85%. This is a 15% reduction on the baseline 100% risk weight for unrated corporate exposures,[32] and would effectively replace the lowest end of the variable discount rate provided by the CRR SME support factor (also set at 15%). This change would also align the SA risk weights for these exposures more closely with the average risk weights that are typically derived under the IRB approach.

3.134 The PRA recognises that this new concession would not represent a full replacement for the SME support factor, as the SME support factor applies a variable discount rate – between 15% and 24% – determined by the type and total amount borrowed by a specific SME. The SME support factor can also apply to an eligible counterparty with an external rating, which the PRA considers inherently contradictory, whereas the new corporate SME sub-class would cover unrated SME corporates only. Nevertheless, the proposed corporate SME preferential risk weight would offset a material part of the impact of the proposed removal of the SME support factor.

3.135 Notwithstanding the mixed evidence around the effectiveness of SME concessions in supporting lending to SMEs, the PRA recognises the importance in avoiding potential disruption to the supply of credit to smaller businesses. In the context of the proposed removal of the SME support factor, and taking into account other existing operational requirements within the prudential framework, the PRA considers overall safety and soundness can be maintained while introducing an 85% risk weight for unrated corporate SMEs.

Treatment of regulatory retail exposures (excluding real estate)

Criteria for identifying regulatory retail exposures

3.136 The PRA proposes to introduce a number of changes to the criteria for identifying regulatory retail exposures (excluding real estate). Specifically, the PRA proposes to clarify the definition of 'regulatory retail' to further its primary objective of safety and soundness by contributing to greater consistency in application.

3.137 The PRA proposes to update and clarify the criteria for identifying regulatory retail exposures and introduce three qualifying requirements. A retail exposure[33] would qualify as a regulatory retail exposure if it meets the conditions set out below:

a. product criteria – the exposure needs to take the form of any of the following types of exposures:

- revolving credits and lines of credit (including but not limited to credit cards, charge cards, and overdrafts);
- personal term loans and leases (including but not limited to instalment loans, vehicle financing arrangements and auto loans and leases, student and educational loans, and personal finance); or
- credit card facilities and commitments to corporate SMEs.

b. value criteria – the value of the exposure (either individually or when aggregated with all other retail exposures) to a single obligor or group of connected clients should not exceed £0.88 million.[34]

c. granularity criteria – the exposure shall be one of a significant number of exposures with similar characteristics such that the risks associated with such lending are substantially reduced.

3.138 Exposures to corporate SMEs that meet all of the above criteria would receive the risk weight treatment proposed under paragraph 3.139. Exposures to corporate SMEs that do not meet each of the above criteria may be treated as unrated corporate SME exposures and risk-weighted at 85% as described in paragraph 3.133. Exposures to natural persons that do not meet these criteria are treated as 'other retail' exposures.

Transactors, non-transactors and other retail exposures

3.139 The PRA proposes to introduce, in line with international standards, more granularity within the retail exposure class, by breaking it down into three sub-exposure classes for the purpose of determining the appropriate risk weight:

- regulatory retail exposures that are 'transactor exposures'– subject to a 45% risk weight;
- regulatory retail exposures that are 'non-transactor exposures'– subject to a 75% risk weight; and
- 'other retail' exposures – subject to a 100% risk weight.

3.140 'Transactors' refers to regulatory retail exposures that are to: (i) obligors in relation to revolving facilities such as credit cards and charge cards where the balance has been repaid in full at each scheduled repayment date for the previous 12 months; and (ii) obligors in relation to overdraft facilities if there have been no drawdowns over the previous 12 months.

3.141 The PRA proposes to introduce a preferential risk weight treatment of 45% for transactors. Due to the characteristics and performance of these exposures, the PRA considers a lower risk weight to be warranted, ie the individuals eligible for these concessionary risk weights are typically considered low risk given their payment history. In addition, the PRA proposes to maintain the 75% risk weight for regulatory retail exposures that are 'non-transactors' and the 100% risk weight for 'other retail' exposures.

3.142 The PRA proposes that the most recent 12 months' consecutive payment history, demonstrating consistent transactor behaviour at an exposure level, would have to be available before the concessionary risk weight for transactors could be applied. The PRA considers this to represent the necessary time required to calibrate a robust data series for an account, especially given the short-term and volatile nature of these products.

Treatment for retail exposures with currency mismatch

3.143 The Basel 3.1 standards introduce a new treatment for retail exposures with currency mismatch, ie exposures where a mismatch is identified between the currency of the loan and that of the obligor's main source of income.

3.144 The PRA proposes to introduce a risk weight multiplier of 1.5x for unhedged foreign exchange retail exposures to individuals, up to a maximum risk weight of 150%. This multiplier would be applied to exposures where a mismatch is identified (at origination and throughout the loan term) between the currency of the loan and that of the obligor's main source of income. The rationale for the introduction of the new treatment is to mitigate the risk of foreign exchange volatility that can affect an obligor's debt-servicing capacity, which is not currently addressed in the CRR.

3.145 The PRA has identified operational challenges firms may face in identifying these exposures, particularly for existing loans. Therefore, the PRA also proposes an 'alternative approach' to identifying currency mismatch where information about an obligor's main source of income is unavailable. Firms would instead need to use (as a proxy) any currency mismatch between the currency of the exposure and the domestic currency of the country of residence of the obligor.

3.146 The PRA proposes that the 'alternative approach' would only be available where the currency of an obligor's main source of income cannot be verified for stock/back book lending. The alternative approach would not be available for new lending following the proposed implementation date of the new rule, and firms would be required to collect and maintain the necessary data on their obligors' income in respect of such exposures.

> **Question 12: Do you have any comments on the PRA's proposals for retail exposures?**

PRA objectives analysis

3.147 The PRA considers the proposals set out in this section would advance its primary objective of safety and soundness as follows:

- The PRA's proposed removal of the 'double discount' between the SME support factor and the existing preferential treatment for retail-qualifying SME lending, and the proposed preferential treatment for corporate SMEs, would reduce the potential for undercapitalisation of risk.
- The PRA considers that there is a strong case from a safety and soundness perspective for updating and clarifying the requirements and risk weights for regulatory retail exposures. Specifically, it would improve the risk-sensitivity of the SA and help ensure firms' RWAs are appropriate given the risks to which they are exposed. The PRA considers that where existing RWAs are being reduced by the proposals set out in this

section, this is warranted from a risk perspective, and the proposals would not have a detrimental impact on the PRA's safety and soundness objective.
- The proposed introduction of the currency multiplier for unhedged retail exposures reflects the increased risk of these exposures due to currency mismatch and the risk of exchange rate volatility.

3.148 The PRA considers that its proposals set out in this section support or maintain its secondary competition objective as follows:

- The proposal to remove the SME support factor is consistent with the PRA's secondary competition objective, as the PRA proposes the same change under the SA and IRB approach (see Chapter 4 for detail of the IRB proposal). The PRA considers that its proposal to introduce the new SME corporate exposure sub-class would improve competition, as it would partially offset the removal of the SME support factor under the SA, whereas the PRA does not propose any offsetting changes in IRB. This could facilitate greater competition between the typically smaller SA firms and the larger IRB firms.
- The PRA considers that the introduction of the transactors sub-exposure class could have an impact on the competition between firms. As the PRA proposes that these exposures are granted a lower risk weight, firms with a lower risk unsecured retail portfolio may benefit from being able to apply lower risk weights to these exposures. This may encourage competition between firms with respect to lending to borrowers who are transactors rather than non-transactors.
- The PRA considers its proposal to implement the currency mismatch multiplier would not have material implications for competition. While the proposed multiplier would only be applicable to firms under the SA, the PRA would expect IRB firms to consider potential currency mismatch in their modelling.

'Have regards' analysis

3.149 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Relevant international standards (FSMA CRR rules):

- The PRA considers its proposals to support its international standards have regard as they align with the Basel 3.1 standards. Removing the SME support factor would also remove potential non-compliance with the Basel 3.1 standards for the treatment of SME exposures.

2. Different business models (FSMA regulatory principles):

- The PRA's proposals on the treatment of regulatory retail are likely to have a greater impact on firms focused on retail lending. There would be operational costs for retail business lines, particularly relating to the assignment of risk weights at exposure level for non-transactors and transactors. The PRA considers these costs to be justified given the improvement in risk-sensitivity.

3. Finance for the real economy (FSMA CRR rules):

- The PRA considers evidence that the SME support factor has supported lending to SMEs to be inconclusive. Therefore, the PRA does not expect its proposed approach to SMEs, when considered in the round including the proposed implementation of the lower risk weight for corporate SMEs in the Basel 3.1 standards, would materially reduce lending to the economy. The introduction of the categories of transactors and non-transactors under regulatory retail could introduce some volatility in risk weights as exposures could move from being classified as transactors to non-transactors over time. This greater risk-sensitivity could result in some procyclicality of risk weights during a stress as more transactors would likely become non-transactors. However, given the proposed risk weights for non-transactors would remain the same as under the CRR (and so risk weights for transactors would at worst increase to the current level in stress), the PRA does not expect this would have a material impact on firms' financing of the economy.

4. Sustainable growth (FSMA regulatory principles) and growth (HMT recommendation letters):

- The PRA considers its proposals would likely have an impact on firms' RWAs. Some of the changes would be likely to increase RWAs, and some reduce them, and the impact on any given firm would depend on its business mix. Where existing RWAs reduce, the proposals would allow firms to reallocate this capital to investments that promote sustainable growth. The proposed approaches should help to ensure firms' RWAs are appropriately calculated for the risks that they are taking on and that firms are able to continue lending throughout the economic cycle, and that if necessary, they can be successfully resolved without disruption to the wider economy.

5. Relative standing of the UK as a place to operate (FSMA CRR rules) and competitiveness (HMT recommendation letters):

- While the PRA's proposals set out in this section should improve safety and soundness and are more aligned to the Basel 3.1 standards than some other jurisdictions have proposed, there could potentially be some impact on the UK's competitiveness. While acknowledging there could be some impact, the PRA does not consider the overall proposals in this section would materially impact the relative standing of the UK as a place for internationally active credit institutions and investment firms to operate, for the reasons set out below:
  - The proposed removal of the SME support factor could be perceived to negatively impact the UK's relative standing, as it would weaken a direct subsidy to SME lending. However, the PRA considers that the proposals to introduce additional risk-sensitivity in the underlying SA risk weights (ie the new 15% reduction for corporate SME exposures and the preferential risk weight treatment of 45% for transactors) would partially offset this impact. The PRA understands that the European Commission proposes to retain the SME support factor, and not to introduce the preferential 85% risk weight for corporate SME exposures.[35] While this is not consistent with the PRA's proposal, the PRA considers the different approaches are unlikely to result in materially dissimilar aggregate RWAs. The PRA anticipates most other jurisdictions would implement the Basel 3.1 standards in a similar manner to the UK, and understands that other jurisdictions do not have an SME support factor. Additionally, the PRA considers SME lending is predominantly undertaken within national markets, with limited cross-border lending. The PRA considers that removal of the SME support factor, alongside the introduction of the new corporate SME risk-weight, would be unlikely to have a significant impact on UK competitiveness.
  - The PRA expects other jurisdictions to also implement the Basel 3.1 standards for regulatory retail exposures.

6. Proportionality (FSMA regulatory principles):

- The PRA considers the proposed removal of the SME support factor to be a proportionate measure to avoid 'double-discounting' of risk weights, and to reduce operational complexities given the proposed introduction of changed approaches for corporate SMEs and regulatory retail exposures.

7. Efficient and economic use of resources (FSMA regulatory principles):

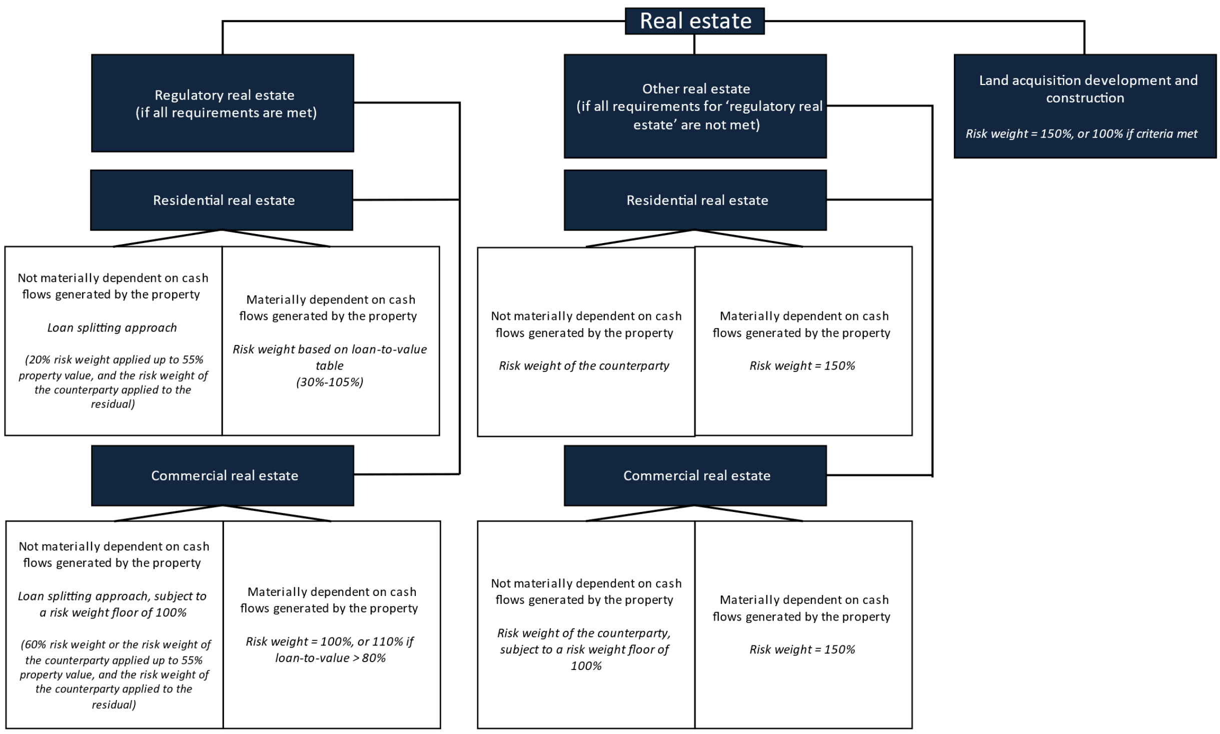
- The PRA considers its proposals would have some impact on the efficient and economic use of PRA resources but does not expect this to be significant. Most of the proposals would potentially require supervisory resources to monitor firms and help ensure the proposed new approaches have been adequately implemented. In particular, supervisors would be required to understand and monitor the split of regulatory retail exposures across transactors and non-transactors and ensure the appropriate risk weight is applied. In the short-term, the PRA expects there would be some additional resource requirement to check firms are applying the appropriate risk weights across regulatory retail. However, the overall incremental increase in supervisory resource required compared to now is unlikely to be material.

Residential and commercial mortgages

3.150 This section sets out the PRA's proposals for the treatment of real estate under the SA to credit risk. The PRA proposes to increase the risk-sensitivity of the treatment for real estate and to introduce a more structured and granular exposure class allocation, which broadly aligns with the taxonomy set out in the Basel 3.1 standards. The overall effect of these changes would bring SA RWAs for real estate closer to those under IRB, particularly for low-risk residential mortgages, while introducing new requirements to help ensure RWAs for real estate exposures are appropriate.

3.151 The diagram below sets out the proposed exposure class allocation structure (see the 'Risk-weighting for real estate sub-classes' part of this section for further information on the proposed risk weights applicable to each sub-class):

Chart 1: Real estate exposure class allocation structure



3.152 In order to meet the definition of a 'regulatory real estate' exposure, exposures would need to meet certain requirements (see paragraph 3.154). These exposures should then be classified as a 'residential real estate' exposure or a 'commercial real estate' exposure.[36]

The PRA proposes to introduce additional clarity on the definition of a residential real estate exposure and a commercial real estate exposure to help ensure greater consistency of exposure allocation across firms.

3.153 The PRA proposes that a residential real estate exposure would mean an exposure secured by property that predominantly has, or will have, the nature of a dwelling and where the property satisfies the applicable laws and regulations enabling it to be occupied for housing purposes. The PRA proposes a list of exposures that would not qualify as a residential real estate exposure, on the basis that the use of these properties is not consistent with residential real estate. The list includes care homes, purpose-built student accommodation, and property that is predominantly used for holiday lets. Where the real estate exposure is not secured by property qualifying as a residential real estate exposure, it would be classified as a commercial real estate exposure, unless it meets the definition of a 'land acquisition, development and construction' (ADC) exposure.

Requirements for 'regulatory real estate'

3.154 The PRA proposes to implement the criteria in the Basel 3.1 standards for a loan to be classified as a 'regulatory real estate exposure' as it considers them to be proportionate and prudent. This includes six requirements, which helps ensure that exposures are secured on property where: (i) it is finished; (ii) there is legal certainty on claims over the property; (iii) the exposure is secured by a first charge over the property;[37] (iv) an assessment is made on the ability of the borrower to repay; (v) it is prudently valued;[38] and (vi) adequate documentation is maintained.[39]

3.155 In cases where the requirements are not met, the PRA proposes that the exposures would be classified as 'other real estate' and receive a higher risk weight, given the elevated risks associated with collateral that does not fully meet the regulatory real estate requirements.

Valuation of real estate collateral

3.156 The PRA proposes that the value of the property should be the value at origination, which it considers to be the valuation obtained by a firm when it issues a new mortgage loan for the purchase of the property, or when the firm issues a new mortgage loan to an existing or new borrower for the property securing the loan (eg when an obligor refinances their mortgage at the end of a fixed period). The PRA considers this approach to strike an appropriate balance between ensuring an accurate valuation is used while mitigating the risk of excessive cyclicality in values that could lead to excessive cyclicality in risk weights.

3.157 The PRA considers it appropriate to allow exceptions for firms to use updated valuations, aligning with the exceptions stated in the Basel 3.1 standards, and proposes to require a new valuation of the property when:

- an event occurs that results in a likely permanent reduction in the property's value;
- there is a significant decrease in the market value of the property as a result of a broader decrease in market prices; or
- modifications are made to the property that unequivocally increase its value. In these instances, firms would be required within a reasonable time to obtain an updated valuation that confirms the new value of the property.

3.158 The PRA acknowledges the potential operational challenges with the implementation of value measured at origination compared to current practice. The PRA proposes that firms would need to make reasonable efforts to access the relevant information for existing loans. If information is unavailable for older loans, firms should use the valuation obtained for the purposes of the most recent revaluation event as set out above, and collect the relevant information going forward. However, because the PRA proposes to allow valuation to be reset when a loan is re-mortgaged, or where an event stated in the prior paragraph occurs, these operational challenges should be greatly mitigated.

3.159 The PRA proposes that the valuation of a property would need to be appraised using prudently conservative valuation criteria, and this valuation would need to be undertaken by an independent valuer who possesses the necessary qualifications, ability, and experience to execute a valuation. These proposed requirements are important to help ensure that the valuation of the collateral securing the loan is prudent given the proposed key role of LTV to calculate the SA risk weight for real estate exposures. Also, the proposal includes further clarity on the definition of loan amount to help ensure there is greater consistency of application across firms.

3.160 The PRA proposes that these valuation requirements apply to residential real estate and commercial real estate.

> **Question 13: Do you have any comments on the PRA's proposal that the value of the property shall be measured at origination and on the proposed approach to determining origination value? Do you have any comments on the proposed prudent valuation criteria?**

Definition of real estate where repayment is materially dependent on cash flow generated by the property

3.161 The PRA proposes to implement an exposure class allocation structure with different risk weight treatments depending on whether repayment of the loan is materially dependent on the cash flows generated by the property. The PRA proposes that the criteria for determining 'materially dependent on the cash flows generated by the property' set out in the Basel 3.1 standards should be implemented, with targeted additional guidance to help ensure there is consistent implementation by firms.

3.162 The PRA considers that firms would need to determine whether the payment of a mortgage loan is materially dependent on cash flows generated by the property over a representative period that should be of sufficient length, and include a mix of good and bad years.

3.163 The PRA considers, based on its observations of the UK market, that a property in multiple occupation does not have the same characteristics as exposures that are not materially dependent on cash flows generated by the property. Therefore, an exposure to a property in multiple occupation would be treated as an exposure that is materially dependent on the cash flows generated by the property.[40]

3.164 The PRA proposes exceptions to the definition of materially dependent on cash flows generated by the property. This would include an exposure to an individual who has no more than three mortgaged residential properties in total (ie a three property limit), regardless of which firm provides the loan on those other properties. The three property limit does not include the individual's primary residence unless the individual depends on cash flows generated by their property portfolio to meet the mortgage payments on that primary residence. If the three property limit is not exceeded, the exposure to the borrower would be treated as a residential real estate exposure that is not materially dependent on cash flows generated by the property. Furthermore, the PRA considers it important for safety and soundness that where a firm becomes aware that an individual breaches the three property limit subsequent to the exposure being originated, the firm should re-classify the exposure as materially dependent on cash flows generated by the property.

3.165 The PRA considers that the proposal promotes the safety and soundness of firms, given the increased risk associated with individuals that have four or more residential property exposures that are materially dependent on cash flows generated by the property.[41]

Risk-weighting for real estate sub-classes

Treatment of 'regulatory residential real estate'

3.166 The PRA proposes to introduce more risk-sensitive risk weights for regulatory residential real estate exposures, based on the outstanding loan amount relative to the value of the residential real estate collateral (ie the LTV), with value calculated as set out above. The PRA considers this would support its primary objective of promoting the safety and soundness of firms given evidence that suggests that the likelihood of a borrower's default and the loss incurred in the event of a default are higher if the LTV is higher. RWAs under this proposal would; therefore, better reflect the risk of such exposures, where lower LTV exposures would be assigned a risk weight that is relatively lower than exposures with higher LTV. The PRA considers these improvements to be one of the most important developments in the SA, and to particularly advance the PRA's competition objective.

3.167 The PRA proposes implementing a loan splitting approach for regulatory residential real estate exposures that are not materially dependent on cash flows generated by the property, which aligns with the approach available in the Basel 3.1 standards, as the approach increases the risk-sensitivity of the risk weight treatment.

3.168 For regulatory residential real estate exposures that are not materially dependent on cash flows generated by the property, the loan splitting approach would assign a 20% risk weight to the part of the exposure up to 55% of the property value. The risk weight of the counterparty[42] would be applied to any residual part of the exposure.[43] This introduction of greater risk-sensitivity is a key part of the PRA's package. A residential real estate loan with an LTV of less than 55%, for example, would see the risk weight fall from 35% under the CRR to 20% in the proposed new approach.

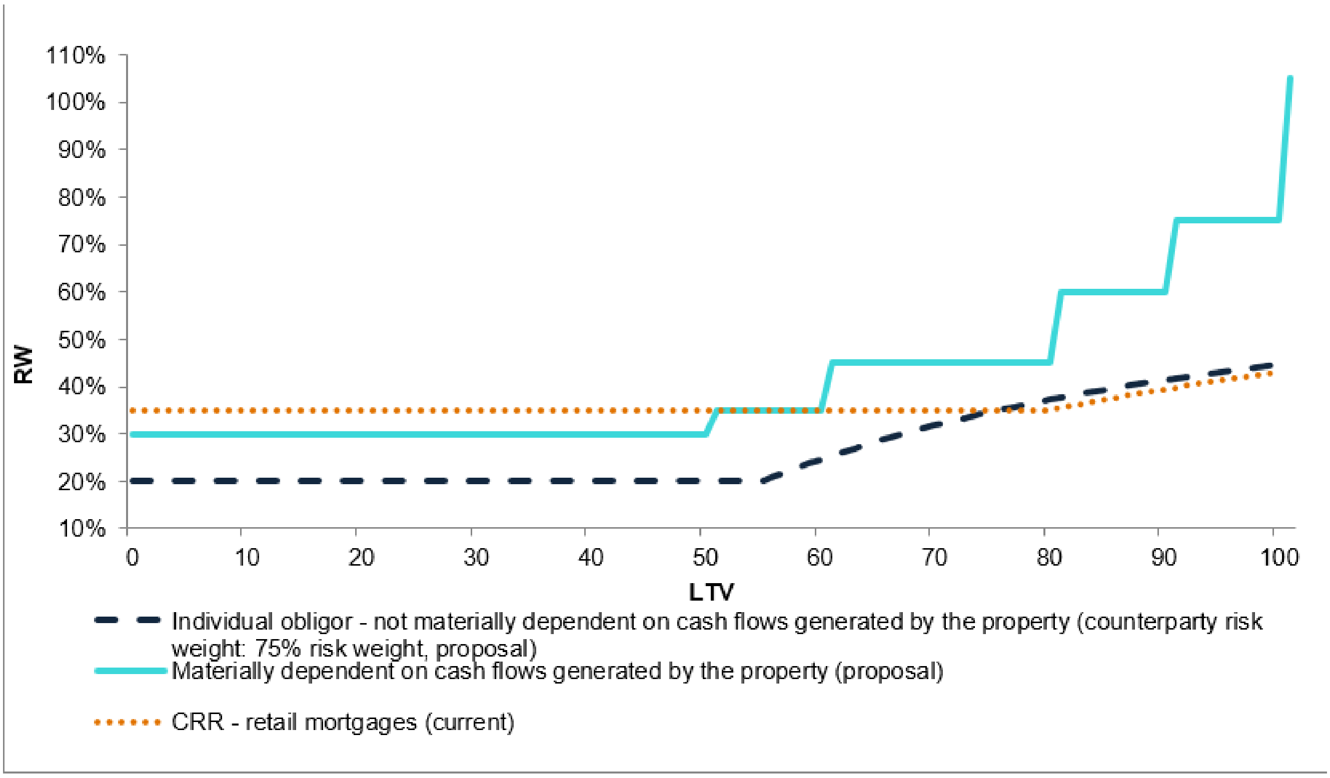
3.169 The PRA also proposes to implement a more conservative risk weight treatment for exposures that are materially dependent on the cash flows generated by the property than the risk weight applicable to exposures that are not materially dependent on the cash flows generated by the property. The PRA considers that these exposures are generally higher risk than where the borrower can service the debt from other sources, due to a positive correlation between the prospects for repayment of the exposure and the prospects for recovery in the event of a default.

3.170 For regulatory residential real estate exposures that are materially dependent on cash flows generated by the property, firms would be required to risk-weight the whole exposure amount of such exposures using the relevant risk weight determined by the LTV of the exposure. Risk weights for these exposures would range between 30% and 105%. In cases where the firm has a junior charge and there are senior charges not held by the firm, the risk weight would be multiplied by 1.25 (unless the LTV is ≤50%, in which case the multiplier need not be applied). The PRA's proposal aligns with the Basel 3.1 standards.

3.171 Social housing exposures[44] would be exempt from the 'materially dependent on cash flows generated by the property' condition, aligning to the exemption set out in the Basel 3.1 standards, and, therefore, would be risk-weighted under the loan splitting approach. To promote the safety and soundness of firms, the PRA considers that for social housing exposures, the risk weight assigned through the loan splitting approach should not be lower than a regulatory residential real estate exposure to an individual. Therefore, the minimum risk weight to be applied to the residual part of the exposure would be 75%.

3.172 Chart 2 below presents the risk weights across LTVs for regulatory residential real estate exposures where the obligor is an individual for: (i) exposures that are materially dependent on cash flows generated by the property; and (ii) exposures that are not materially dependent on cash flows generated by the property. These proposed treatments are presented with the existing CRR treatment for retail mortgages.

Chart 2: Risk weights – Regulatory residential real estate exposures



Treatment of 'regulatory commercial real estate'

3.173 Given default experience in stressed environments and broader factors such as market price stability, the PRA continues to consider that the risk associated with commercial real estate lending warrants an SA risk weight that is no lower than 100%. The PRA considers this is warranted in order to promote the safety and soundness of firms and address potential financial stability concerns.

3.174 The PRA, therefore, proposes to assign a 100% risk weight floor to the loan splitting approach for regulatory commercial real estate exposures that are not materially dependent on cash flows generated by the property. This means that the risk weight should be calculated using the loan splitting approach, and if the resulting risk weight is less than 100%, it should be floored at 100%. The PRA considers this proposal to be clearer and simpler to implement than the existing approach to risk-weighting commercial real estate under SA in the CRR and PRA Rulebook.

3.175 For the purpose of the loan splitting approach for regulatory commercial real estate exposures that are not materially dependent on cash flows generated by the property, the PRA proposes that firms would risk-weight the exposure by assigning the risk weight of the counterparty or 60%, whichever is lower, to the part of the exposure up to 55% of the property value where the value is the origination value, as calculated in accordance with the valuation of real estate collateral section above. The risk weight of the counterparty[45] would be applied to any residual part of the exposure. If the resultant risk weight is lower than 100%, a risk weight of 100% would be applied to the exposure.[46]

3.176 For exposures that are classified as regulatory commercial real estate exposures that are materially dependent on cash flows generated by the property, firms would apply a 100% risk weight, unless the LTV of the exposure is greater than 80%, in which case the risk weight would be 110%. In cases where a firm has a junior charge and there are senior charges not held by the firm, the applicable risk weight would be multiplied by 1.25 (unless the LTV is ≤60%, in which case the multiplier need not be applied).

Treatment of ‘other residential real estate’

3.177 Where a residential real estate exposure does not meet all of the requirements for regulatory residential real estate, the PRA proposes that the exposure would be classified as ‘other residential real estate’ (for example, if the property is incomplete or under construction). These exposures would receive a higher risk weight given the elevated risks, such as those relating to the quality of the collateral or the property being incomplete or under construction.

3.178 The PRA proposes that firms would be required to risk-weight ‘other real estate’ exposures that are residential real estate exposures and not materially dependent on cash flows generated by the property according to the risk weight of the counterparty.[47]

3.179 To ensure consistency with regulatory residential real estate, social housing exposures would be subject to a minimum risk weight of 75%.

3.180 For ‘other real estate’ exposures that are residential real estate exposures and materially dependent on cash flows generated by the property, the PRA proposes to apply a risk weight of 150%, as the PRA considers that these are generally higher risk than exposures where the borrower can service the debt from other sources.

Treatment of ‘other commercial real estate’

3.181 Where a commercial real estate exposure does not meet all of the requirements for regulatory commercial real estate, the PRA proposes that the exposure would be classified as 'other commercial real estate'.

3.182 The PRA proposes that for 'other commercial real estate' exposures that are not materially dependent on cash flows generated by the property, the risk weight assigned would be the risk weight of the counterparty,[48] with a risk weight floor of 100%.

3.183 For 'other commercial real estate' exposures which are materially dependent on cash flows generated by the property, the PRA proposes to apply a risk weight of 150%, aligning with the Basel 3.1 standards.

Land acquisition, development, and construction exposures

3.184 The Basel 3.1 standards introduce a specific treatment for 'land acquisition, development, and construction' (ADC) for properties where the source of repayment at origination of the exposure is either the future and uncertain sale of the property, or cash flows whose source is substantially uncertain.

3.185 The PRA proposes higher risk weights for ADC exposures compared to most non-ADC exposures to support the PRA's primary objective of safety and soundness and to reflect the higher risk of these exposures, given that the source of repayment of the loan is a planned, but uncertain sale of the property, or substantially uncertain cash flow.

3.186 The PRA proposes to classify an ADC exposure as an exposure to a corporate or special purpose entity financing any land acquired for development and construction purposes, or financing development and construction of any residential or commercial real estate.

3.187 The PRA proposes that firms risk weight an ADC exposure at 150%, except for residential real estate where certain conditions[49] are met and a risk weight of 100% may be assigned.

Currency mismatch multiplier

3.188 The PRA proposes a new treatment for unhedged residential real estate exposures with a currency mismatch, operating in a similar manner as noted in the 'Treatment for retail exposures with currency mismatch' part of the 'Lending to individuals and small and medium-sized enterprises' section (see paragraphs 3.143–3.146).

3.189 The PRA proposes to introduce a risk weight multiplier of 1.5x for unhedged residential real estate exposures to individuals, up to a maximum risk weight of 150%. This multiplier would be applied to exposures where a mismatch is identified (at origination and throughout the loan term) between the currency of the loan and that of the obligor's main source of income.

3.190 The PRA proposes that the 'alternative approach' to identifying exposures with currency mismatch would also be available for unhedged residential real estate lending (see paragraph 3.146).

> **Question 14: Do you have any comments on the PRA's proposed approach to risk-weighting real estate exposures?**

PRA objectives analysis

3.191 The PRA considers that the introduction of a more risk-sensitive SA approach for real estate exposures, as proposed in this section, including the requirements that would need to be met in order to qualify for lower risk weights, promotes the safety and soundness of firms. The PRA also considers that the proposed risk weight approach for commercial real estate exposures promotes the PRA's primary objective. Given the default experience in historical stressed environments and broader factors such as market price stability, the PRA considers that the risk associated with commercial real estate lending warrants a risk weight that is no lower than 100%.

3.192 The PRA considers the proposed approach to the valuation of real estate to strike the right balance between ensuring an accurate valuation is used, while mitigating the risk of excessive variability in values which could lead to cyclicality in risk weights (given the duration before re-mortgaging takes place in the UK is, on average, around three years).

3.193 The more risk-sensitive treatment for real estate exposures should help ensure RWAs are reflective of the relative risk of the exposure and the PRA considers that where existing RWAs increase or decrease, this is warranted based on risk.

3.194 The PRA's proposals set out in this section would advance its secondary competition objective as they aim to introduce clarity and consistency in the application of the SA approach to real estate, and reduce the gap in SA risk weights relative to those modelled under the IRB approach, particularly for low-risk residential mortgages. The PRA acknowledges that there would be some differences between the classification and allocation criteria of real estate exposures across firms using the SA and IRB. However, the application of the SA for real estate exposures should be consistently applied across firms, and firms using IRB for the calculation of credit risk RWAs would have to apply the SA proposed in this section for the purpose of the output floor (subject to the PRA's proposal on implementation of the output floor; see Chapter 9).

'Have regards' analysis

3.195 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Relevant international standards (FSMA CRR rules):

- The proposals for the overall treatment of real estate exposures are intended to be aligned with international standards set out by the BCBS, with clarification on certain operational considerations that should achieve a proportionate approach that meets the aims of the Basel 3.1 standards. The PRA considers that it has proposed a pragmatic and balanced approach for valuation requirements and the definition of residential real estate that aligns with the Basel 3.1 standards while minimising the potential unintended consequences of a non-risk-sensitive approach. The PRA acknowledges that the proposal for commercial real estate exposures is more prudent than the baseline recommended by the Basel 3.1 standards; however, the approach aligns with the BCBS national discretion to increase risk weights where national authorities deem it appropriate. In the case of the UK market, the PRA considers that UK firms' historical loss experience continues to justify the higher risk weight.

2. Relative standing of the UK as a place to operate (FSMA CRR rules) and competitiveness (HMT recommendation letters):

- The proposed approach would implement the prudent valuation requirements set out in the Basel 3.1 standards, and, therefore, prudent valuation practice should align with other major jurisdictions. The proposed approach for calculating origination value should help ensure that valuations of property collateral appropriately reflect risk, including when valid re-valuation events occur. Proposals from other jurisdictions may implement origination value requirements in somewhat different ways, appropriate to their residential and commercial real estate markets, but the PRA generally expects that the outcomes produced would be broadly comparable. Also, the PRA considers that mortgage lending is generally undertaken within national markets, with limited cross-border lending. The proposal aims to implement the intended principles set out in the Basel 3.1 standards with adjustments to address operational and prudential concerns.
- The proposed allocation of exposures aligns with the Basel 3.1 standards and should align with other major jurisdictions. For exposures deemed materially dependent on cash flows generated by the property, the PRA proposes to apply a three property limit to the borrower's total portfolio, rather than to exposures to a single institution as proposed by

the European Commission, as the PRA considers its proposed approach is more reflective of the risk.

- For most commercial real estate exposures,[50] the proposal is not a change from the existing CRR requirements, and the PRA considers the proposal would best advance its primary objective. The PRA acknowledges that other jurisdictions may apply lower risk weights for commercial real estate exposures, which may raise questions around competitiveness, but considers that its proposal is appropriate and necessary to support the safety and soundness of firms, which over the longer term would underpin the competitiveness of the UK sector.

3. Different business models (FSMA regulatory principles):

- The allocation of real estate exposures would have a varied impact on different business models. For example, firms that specialise in financing buy-to-let properties are likely to experience a larger impact, given the proposed higher risk weights for exposures with material dependence on cash flows generated by a property than for exposures that do not have material dependence on cash flows generated by the property. However, the PRA considers this to appropriately reflect the relative risk of the exposures and to be prudentially justified. The PRA also notes that the proposed buy-to-let risk weights for lower LTV exposures are lower than under the CRR.
- The PRA acknowledges that the proposed approach may affect self-build property mortgages, as these would not meet the 'finished property' requirement during the construction phase, but considers the greater risk of these exposures justifies a higher risk weight. The PRA's proposal to include a list of properties that do not meet the proposed residential real estate definition may also impact firms that specialise in these markets, but is designed to promote a consistent and robust implementation.
- The PRA proposes to not materially change the risk weight treatment for commercial real estate in the CRR, except for the increased risk-sensitivity on high LTV commercial real estate exposures. Where firms are concentrated in high LTV commercial real estate lending, there would be a greater impact, as the PRA would expect higher RWAs for this lending than under the CRR, consistent with the aim to increase risk-sensitivity across the SA.
- Different business models would overall be impacted according to the concentration of business in different types of real estate lending. Firms that are highly concentrated in lower LTV owner-occupied residential lending would likely experience a reduction in RWAs compared to today, while those firms that are focused on higher risk lending may see increased RWAs. This reflects the more risk-sensitive nature of the proposed approach compared to the CRR which, as set out above, supports the PRA's primary and secondary objectives.

4. Sustainable growth (FSMA regulatory principles) and growth (HMT recommendation letters):

- The PRA considers that the proposals should help ensure that firms' RWAs are sufficient given the risks to which they are exposed. That, in turn, would help ensure that financing is available over a cycle and that growth is sustainable. The proposed implementation of origination valuation requirements is intended to strike a pragmatic balance between risk-sensitivity and achieving the broad outcome intended by the Basel 3.1 standards. The proposal should help mitigate potential procyclicality in RWAs due to valuation changes, thereby enhancing the ability of firms to continue lending, and supporting growth of the economy in the long run throughout the economic cycle.
- The proposed risk weight treatment for commercial real estate in the SA would not be materially different from the existing SA for UK firms, and, therefore, should not negatively impact sustainable growth. Significantly lower risk weights for commercial real estate could potentially result in undercapitalisation of risk, and, therefore, have negative financial stability implications, which would undermine sustainable growth.
- The PRA acknowledges that the proposed approach to real estate exposures could lead to further sustainable growth in lower LTV lending, while growth in higher LTV lending may be impacted.
- Overall, the PRA considers that the proposed treatment of real estate exposures helps ensure that firms are adequately capitalised for the risks that they are facing. This should help enhance: (i) the ability of firms to provide finance to households in the long run throughout the economic cycle; and (ii) the aim that firms can be successfully resolved if necessary without significant disruption to the wider economy.

Capital instruments, defaulted exposures, and high-risk items

3.196 This section sets out the PRA's proposals for the SA to credit risk for: (i) equities, subordinated debt and other capital instruments; (ii) defaulted exposures; and (iii) high-risk items. The changes in the Basel 3.1 standards in these areas seek to enhance the risk-sensitivity and robustness of the risk-weighted treatment for these exposures. The PRA supports these changes as they would result in the SA framework better reflecting the relative risk of different types of exposures, and this improved risk-sensitivity would contribute to the safety and soundness of firms.

Equities, subordinated debt and other capital instruments

Equity exposures

3.197 As set out in Chapter 4, the PRA proposes to remove the use of IRB modelling to calculate RWAs for 'equity' exposures. That means all equity exposures would be subject to the proposed SA treatment set out in this section.

3.198 The PRA considers that the CRR definition of equity exposures[51] lacks clarity, particularly concerning the other instruments that structurally and economically behave like equity and should be treated as equity exposures. To provide enhanced clarity and to help ensure that firms assign exposures to the correct classes, the PRA proposes to clarify the definition of equity exposures.[52] The PRA also proposes changes to the risk-weighting of equity exposures, in line with the Basel 3.1 standards.

3.199 The CRR requires SA risk weights of 100% or 150% for equities, and a 150% risk weight applies to items identified as 'high risk'. This compares with risk weights of 190%, 290%, or 370% under the 'simple risk weight' approach for IRB, which is the IRB approach to equity exposures most commonly used by UK firms. The PRA's proposes to risk weight equity exposures at 250%, or at 400% if classified as 'speculative unlisted equity exposures'. This aligns with the Basel 3.1 standards.

3.200 The Basel 3.1 standards define 'speculative unlisted equity' as equity investments in unlisted companies that are invested for short-term resale purposes, or are considered venture capital or similar investments which are subject to price volatility and are acquired in anticipation of significant future capital gains.

3.201 The PRA proposes that the speculative unlisted equity category would only include venture capital exposures. These exposures would be assigned a 400% risk weight and all other exposures meeting the definition of equity exposures would receive a 250% risk weight. The PRA proposes to define venture capital as:

''unlisted' equity investments held with the objective of providing funding to newly established enterprises, including to the development of a new product and related research for the enterprise in order to bring this product to the market, to the build-up of the production capacity of the enterprise or to the expansion of the business of the enterprise'.

3.202 The PRA proposes that the new SA equity risk weights should be phased-in over a five-year period under the SA approach as set out in Table 6. The PRA also proposes to introduce an IRB equity transitional approach that would only apply to firms with IRB permissions, and which should be considered in combination with the changes described in this section (see Chapter 4 for further detail). Overall, the PRA approach aims to allow firms to smoothly adjust to the new SA risk weights, avoiding risk weight volatility during the transition period.

Table 6: Equity exposure risk weights over the five-year phase in period

Time period[53]	Equity exposures not considered venture capital	Equity exposures considered venture capital
1 January 2025 to 31 December 2025	100%	100%
1 January 2026 to 31 December 2026	130%	160%
1 January 2027 to 31 December 2027	160%	220%
1 January 2028 to 31 December 2028	190%	280%
1 January 2029 to 31 December 2029	220%	340%
End-state (1 January 2030 onwards)	250%	400%

Subordinated debt and other capital instruments[54]

3.203 To better reflect the risk profile of subordinated debt and other capital instruments that are not equity exposures, ie a higher risk of loss compared to holding a senior loan to the same entity, the PRA proposes to increase risk weights for subordinated debt and other capital instruments to 150% from the existing 100% under the CRR. The PRA considers its proposal would increase the risk-sensitivity of the SA. This would be in line with the Basel 3.1 standards.

Defaulted exposures

3.204 The PRA proposes to clarify the criteria that are used under the SA to determine whether exposures are treated as retail exposures for the purpose of applying the definition of default (see Chapter 4 for further proposed changes relating to the definition of default). Additionally, the PRA proposes to introduce the following SA risk weights for defaulted exposures:[55]

- 150% where specific provisions are less than 20% of the outstanding loan amount;
- 100% where specific provisions are equal to or greater than 20% of the outstanding loan amount; and

- a preferential flat risk weight of 100% for residential real estate exposures where repayments do not materially depend on cash flows generated by the property.

3.205 The PRA's proposals would change the existing treatment of defaulted exposures as follows:

- The PRA proposes that specific provisions should be compared against the outstanding loan amount (gross of specific provisions) to determine whether the 150% or 100% risk weight applies. This differs to the CRR which compares specific provisions to the unsecured part of the exposure value (gross of specific provisions). The PRA considers its proposal to be a more prudent treatment and to align with the Basel 3.1 standards.
- The preferential flat 100% risk weight treatment would be restricted to exposures secured on residential real estate where repayments do not materially depend on cash flows generated by the property. This differs to the CRR where the treatment is available for all exposures secured on residential and commercial property, provided they are 'fully and completely secured'. The PRA considers its proposal to better reflect the riskiness of defaulted assets.

High-risk items

3.206 CRR Article 128 relating to items associated with particular high risk has already been brought into PRA rules. Parts of the article would become redundant following the implementation of the proposals set out in this CP; however, the PRA considers it prudent to retain some elements of it as set out below.

Speculative immovable property financing

3.207 'Speculative immovable property financing' under PRA Rulebook Article 128(2)(c)[56] is currently defined in the CRR Article 4(79) as 'loans for the purposes of the acquisition of or development or construction on land in relation to immovable property, or of and in relation to such property, with the intention of reselling for profit'.

3.208 Under PRA Rulebook Article 128(2)(c), speculative immovable property financing would be treated as exposures associated with particularly high risk and should be assigned a 150% risk weight. The application of this treatment ultimately hinges on a borrower's intention to resell the property for a profit, regardless of whether it is to construct, develop or acquire the property. This means it potentially covers a very broad range of circumstances and borrowers, ie from individuals 'flipping' a single property, to real estate construction firms building large scale new developments.

3.209 The PRA proposes to remove PRA Rulebook Article 128(2)(c) and to instead introduce an explicit treatment for ADC as set out in the 'Residential and commercial mortgages' section. The proposals would capture loans to companies or special purpose vehicles financing ADC of any residential or commercial property. A 150% risk weight would apply to these exposures unless specific criteria are met.

3.210 The PRA considers that ADC captures the type of activities with the most risk that currently fall under PRA Rulebook Article 128(2)(c), but exposures to individuals whose intention is to resell for profit would not be captured.

3.211 The PRA proposes that a real estate exposure to an individual (out of scope of ADC) in respect of any land acquired for development and construction purposes, or for the purposes of financing development and construction of any residential or commercial real estate, would be treated as an 'other real estate exposure' (as set out in the 'Residential and commercial mortgages' section).

Items associated with particularly high risk

3.212 Under PRA Rulebook Articles 128(1) and 128(3),[57] a 150% risk weight would be assigned to exposures that are associated with particularly high risk. When assessing whether an exposure is associated with particularly high risk, firms should consider: (i) whether there is a high risk of loss as a result of a default of the obligor; and (ii) whether it is possible to adequately assess whether the exposure falls under point (i).

3.213 The PRA proposes to retain PRA Rulebook Articles 128(1) and 128(3), particularly for exposures where there is evidence of a higher risk of loss given default (or where it is not possible to adequately assess the risk), but they are not in default. The PRA considers this to preserve existing risk-sensitivity in the framework.

3.214 The PRA proposes to remove Article 128(2) in light of the proposals on speculative immovable property financing (see above) and on the treatment of equity exposures (as set out in the 'Equity exposures' part of this section above).

> **Question 15: Do you have comments on the PRA's proposals on capital instruments, defaulted exposures, and high-risk items?**

PRA objectives analysis

3.215 The PRA considers that its proposals set out in this section would enhance its safety and soundness objective:

- The PRA's proposals on equity exposures, subordinated debt, and other capital instruments should improve the risk-sensitivity and consistency of application of SA risk weights. The PRA considers that its proposals would help ensure that firms' RWAs better reflect the risks associated with equity and other capital instruments. For example, applying higher risk weights for equity exposures than subordinated debt reflects that equity exposures are riskier given their position in the creditor hierarchy. This would help ensure that firms are able to continue lending throughout the economic cycle, and that they can be successfully resolved if necessary, without significant disruption to the wider economy.

- The proposal to compare specific provisions against the outstanding loan amount for defaulted exposures (instead of against the unsecured part of the exposure value under the CRR) better reflects the risk and the PRA considers it to achieve an appropriate level of conservatism.
- While the PRA proposes to address high-risk variants of different types of exposures more specifically within each exposure class, the proposal to retain some provisions relating to high-risk items (PRA Rulebook Articles 128(1) and 128(3)) helps ensure that existing risk-sensitivity in the framework is maintained.

3.216 The PRA considers that its proposals set out in this section would enhance or maintain its secondary competition objective:

- The PRA acknowledges its proposals on equity exposures would increase RWAs for SA firms but may decrease RWAs for some firms using the IRB approach that would have to use the SA equity risk weights under the PRA's proposals (depending on the IRB equity approach they are currently using to risk-weight equity exposures). However, while there may be some impact on the cost of financing for these exposures, the proposal should also enhance competition between different types of firms as the treatment of equity exposures at the end of the equity phase-in period would be the same for SA and IRB firms, given the modelling of equity exposures under IRB would be prohibited and all exposures would be risk-weighted under SA. The narrowing of the gap between the SA and IRB approaches should facilitate competition.

'Have regards' analysis

3.217 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Sustainable growth (FSMA regulatory principles) and growth (HMT recommendation letters):

- The PRA considers the proposals set out in this section would increase RWAs for some subordinated debt exposures and equity exposures from the existing treatment, but it considers this to be prudentially justified as it reflects the relative degree of risk associated with the exposures, ie the higher risk of equity exposures compared to subordinated debt and of both compared to holding a senior loan to the same entity. The proposed approach would help ensure that firms calculate RWAs that adequately reflect the risks on their balance sheets. This helps ensure that firms are able to continue lending throughout the economic cycle, and that they can be successfully resolved, if necessary, without significant disruption to the wider economy.

2. Proportionality (FSMA regulatory principles):

- The PRA considers its proposed changes to the treatment of equity exposures to be proportionate. Allocating equity exposures to the different categories would result in some moderate initial costs for firms, but they should not be disproportionate to the expected prudential benefits. The PRA considers its proposed approach for venture capital exposures to be proportionate as it should help ensure the riskiest exposures would be subject to the higher 400% risk weight while less risky exposures would be subject to the lower 250% risk weight.

3. Relevant international standards (FSMA CRR rules):

- The PRA considers that its proposals align with the Basel 3.1 standards:
  - The Basel 3.1 standards include a category of speculative unlisted equity and the PRA considers the intended scope of this to be open to interpretation. The PRA's proposal for speculative unlisted equity achieves what the PRA considers to be a faithful and proportionate implementation of the Basel 3.1 standards that seeks to achieve an appropriate balance between prudence and risk-sensitivity. The PRA considers its proposal aligned with the treatment for capital instruments set out in the Basel 3.1 standards.
  - The PRA considers its proposals on defaulted items and items associated with particularly high risk to support its international standards have regard as they align with the Basel 3.1 standards.

4. Relative standing of the UK as a place to operate (FSMA CRR rules):

- The PRA considers that the proposals set out in this section would not materially impact the relative standing of the UK:
  - For equity exposures, the PRA is aware that regulators and policymakers in some other jurisdictions,[58] for example, the European Commission, propose a more limited scope of exposures that would be assigned a 400% risk weight, ie excluding equity exposures that are long-term equity investments from the 400% risk weight category. Such a treatment would result in lower risk weights being applied to these exposures. However, the PRA considers its approach to strike an appropriate balance between risk-

sensitivity, prudence, and operational simplicity. The PRA does not expect its proposals to have a material impact on the relative standing of the UK as these exposures only account for a relatively immaterial proportion of UK firms' credit RWAs.

- For the treatment of defaulted exposures, the PRA is aware that some other countries[59] may not fully align with the Basel 3.1 standards and apply approaches the PRA considers to be less prudentially sound than the Basel 3.1 standards. Therefore, the proposed faithful implementation of the Basel 3.1 standards could impact the UK's relative standing; although the PRA does not expect the impact of this to be material.
- For treatment of exposures associated with particularly high risk, the PRA considers its proposals to maintain the relative standing of the UK. For example, other regulators have also proposed to remove the category of speculative immovable property financing.

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1. At this stage, the PRA does not propose to amend the technical standards on the identification of general and specific credit risk adjustments as set out in Commission Delegated Regulation 183/2014. In due course, the PRA intends to review these technical standards in the context of the accounting frameworks in place in the UK.
2. A proposal to introduce a new SS 'Definition of default' that would apply to firms using the SA is set out in Chapter 4.
3. External ratings need to be issued by a recognised external credit assessment institution (ECAI).
4. See Chapter 2 – Scope and levels of application, which also describes the position for PRA-designated financial holding companies or mixed financial holding companies related to those UK banks and building societies.
5. The PRA expects all permissions granted under CRR Article 113(6) and the final sub-paragraph of CRR Article 129(1) to be saved by HMT for firms implementing the Basel 3.1 standards. This would result in permissions granted under CRR Articles 113(6) and 129(1) being deemed to be permissions under Articles 113(6) and 129(1B) of the Credit Risk: Standardised Approach (CRR) Part. For TCR firms see paragraph 2.26 of Chapter 2.
6. The PRA proposes that firms using the IRB approach that are subject to the proposed output floor would not have to perform separate due diligence for the purpose of calculating SA risk weights and would be permitted to rely on the risk management performed in accordance with their approved IRB approach. However, where such a firm's internal rating of an exposure maps to a CQS higher than implied by the external rating, the firm should uplift the risk weight to a CQS at least one higher than the CQS indicated by the counterparty's external credit rating.
7. The use of external credit ratings in capital requirements is prohibited under the Dodd-Frank Act in the USA, so the USA is expected to implement an alternative methodology permitted under the Basel 3.1 standards.
8. Basel CRE 20.94, footnote 43.
9. The definition in the Basel 3.1 standards also includes the following: 'Retail credit lines may be considered as unconditionally cancellable if the terms permit the institution to cancel them to the full extent allowable under consumer protection and related legislation'.
10. The BCBS analysis is referenced in the **BCBS second consultative document standards: Revisions to the Standardised Approach for credit risk** under section 1.7: Off-balance sheet exposures.
11. Trigger events occur when a counterparty fails to perform a non-financial obligation. Trigger events differ from default events as trigger events relate to the underlying transaction (between the counterparty and third party) rather than whether the counterparty has defaulted or not. When a trigger event occurs, it enables the third-party beneficiary to

make a claim which the firm needs to pay, which means the exposure comes on-balance sheet.

12. The PRA proposes some drafting amendments relating to these articles; however, this would not substantively change the effect of these articles.

13. CRR Article 117 (2).

14. Article 117 in the Credit Risk: Standardised Approach (CRR) Part.

15. CRR Article 119 (2).

16. CRR Article 119 (3).

17. Article 121 (1A and 1B) of the Credit Risk: Standardised Approach Part.

18. Exposures to unrated institutions classified as Grade A may be assigned a risk weight of 30% if that unrated institution has: (i) a Common Equity Tier 1 ratio which meets or exceeds 14%; and (ii) a Tier 1 leverage ratio which meets or exceeds 5%.

19. Where the exposure is not in the local currency of the jurisdiction of incorporation of the debtor institution, or the exposure is booked in a branch of the debtor institution in a foreign jurisdiction and is not in the local currency of the jurisdiction in which the branch operates; and the exposure is not a self-liquidating, trade-related contingent item arising from the movement of goods with an original maturity of less than one year.

20. See footnote 18 which sets out that exposures to unrated institutions classified as Grade A may be assigned a risk weight of 30%, and, therefore, the proposed risk weight for exposures to unrated covered bonds issued by such institutions would be 15%.

21. See link for the European Commission’s proposal: **Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Regulation (EU) No 575/2013 as regards requirements for credit risk, credit valuation adjustment risk, operational risk, market risk and the output floor**.

22. Data included: data reported and received from firms, Pillar 3 disclosures, and the risk weight treatment for rated ‘corporate’ exposures.

23. The PRA proposes that an issuer rating should not be used.

24. See footnote 21 for the European Commission’s proposal.

25. See link for the OSFI’s policy: **Capital Adequacy Requirements (CAR) 2023**.

26. **Regulatory Consistency Assessment Programme (RCAP) - Assessment of Basel III regulations - European Union.**

27. Regulation (EU) 2019/876 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements, and Regulation (EU) No 648/2012.

28. Qualifying SME exposures are defined as follows: (a) the exposure shall be included either in the retail or in the corporates or secured by mortgages on immovable property classes, and exposures in default shall be excluded; and (b) an SME is defined in accordance with Commission Recommendation 2003/361/EC of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises.

29. A corporate SME means an SME as defined in Article 4(1)(128D) of the CRR, save that in Article 2 of the Annex to Commission Recommendation 2003/361/EC only the annual turnover would be taken into account and the annual turnover figure of EUR 50 million would be replaced with an annual turnover figure of £44 million (see Chapter 13 – Currency redenomination).

30. Analysis by the EBA can be accessed using the following URL: **EBA Report on SMEs and SME Supporting Factor** .

31. See footnote 29 on the definition of SMEs.

32. A risk-sensitive approach for unrated corporates that are not SMEs is proposed in the section on 'Exposures to corporates and specialised lending' setting a 135% risk weight for Non-IG or 65% risk weight for IG corporates.

33. As set out in the Credit Risk: Standardised Approach (CRR) Part, the PRA's proposed definition is that a retail exposure means an exposure to: (a) one or more natural persons; or (b) a corporate SME that falls within the definition of regulatory retail exposure, including exposures that are the present value of minimum lease payments (as defined in Article 134(7)), but excluding real estate exposures, derivatives and other types of securities (such as bonds and equities).

34. The PRA proposes that thresholds stated in EUR or USD in the Basel 3.1 standards are converted into GBP (see Chapter 13).

35. See footnote 21 for the European Commission's proposal.

36. A 'regulatory residential real estate exposure' means a residential real estate exposure that meets the requirements to be deemed a 'regulatory real estate exposure'. A 'regulatory commercial real estate exposure' means a commercial real estate exposure that meets the requirements to be deemed a 'regulatory real estate exposure'.

37. The exposure is secured by a first charge over the property, or, if it is secured by a junior charge, the institution also holds any first charge over the same property.

38. The value of the property must not depend materially on the performance of the borrower. See 'Valuation of real estate collateral' part of this section.

39. Article 124A in the Credit Risk: Standardised Approach (CRR) Part.

40. An exposure secured on a house in multiple occupation (HMO) would always be treated as materially dependent on the cash flows generated by the property, and would not be excluded from the definition of materially dependent on the cash flows generated by the property. Exposures to an HMO would be considered to be part of the borrower's portfolio for the purposes of assessing the 'three property limit'.

41. The proposal is consistent with the PRA's approach to portfolio landlords, as set out in SS13/16.

42. Relevant counterparty risk weights are: a) for exposures to individuals, 75%; b) for exposures to SMEs, 85%; c) for exposures to other counterparties, unless the exposure is a social housing exposure, the risk weight that would be assigned to an unsecured exposure to that counterparty.

43. For example, for a loan of £80,000 to an individual secured on a property valued at £100,000, the firm would apply a risk weight of 20% to £55,000 of the exposure, and a risk weight of 75% to the residual exposure of £25,000. This gives total RWAs for the exposure of £29,750 = (0.20 * £55,000) + (0.75 * £25,000).

44. A public housing company or not-for-profit association regulated in the UK that exists to serve social purposes and to offer tenants long-term housing.

45. See footnote 42 for the relevant counterparty risk weights.

46. For example, for a loan of £80,000 to an SME secured on a property valued at £100,000, the firm would calculate the resultant risk weight for the exposure. To calculate the resultant risk weight under the loan splitting approach, the firm would apply a 60% risk weight (given 60% is less than the counterparty risk weight of 85%) to £55,000 of the exposure, and a risk weight of 85% to the residual exposure of £25,000. This gives total RWAs for the exposure of £54,250 = (0.60 * £55,000) + (0.85 * £25,000). As the resultant risk weight (£54250/£80000 = c. 68%) is less than 100%, a 100% risk weight would be applied to the exposure. This would result in RWAs of £80,000 being applied for the exposure.

47. See footnote 42 for the relevant counterparty risk weights.

48. See footnote 42 for the relevant counterparty risk weights.

49. The following criteria would need to be met: (a) the exposure meets the prudent valuation requirements; and (b) at least one of the following conditions is met: (i) legally binding pre-sale or pre-lease contracts, for which the purchaser or tenant has made a substantial cash deposit which is subject to forfeiture if the contract is terminated, amount to a significant portion of total contracts; or (ii) the borrower has substantial equity at risk.

50. The risk weight applied to commercial real estate exposures would be different to the CRR requirements in the following circumstances: 1) a high LTV exposure to 'regulatory commercial real estate' that is not materially dependent on the cash flows generated by the property, and to a counterparty that has a counterparty risk weight of more than 100%; 2) an exposure to 'regulatory commercial real estate' that is materially dependent on the cash flows generated by the property, and the LTV of the exposure is greater than 80%; 3) an exposure to 'other commercial real estate' that is not materially dependent on the cash flows generated by the property, and to a counterparty that has a counterparty risk weight of more than 100%; and 4) an exposure to 'other commercial real estate' that is materially dependent on the cash flows generated by the property.

51. CRR Article 133: The following exposures shall be considered equity exposures: (a) non-debt exposures conveying a subordinated, residual claim on the assets or income of the issuer; (b) debt exposures and other securities, partnerships, derivatives, or other vehicles, the economic substance of which is similar to the exposures specified in point (a).

52. The PRA proposes to define equity exposures as follows: 'An instrument is considered to be an equity exposure if it meets all of the following requirements: (1) the return of invested funds can be achieved only by the sale of the investment or sale of the rights to the investment or by the liquidation of the issuer; (2) It does not embody an obligation on the part of the issuer; and (3) It conveys a residual claim on the assets or income of the issuer.'

53. Based on the PRA's proposed implementation date of 1 January 2025.

54. The treatment only applies to subordinated debt, equity, and other regulatory capital instruments issued by either corporates or banks, provided that such instruments are not already deducted by the firm from regulatory capital, risk-weighted at 250% in accordance with CRR Article 48(4), or risk-weighted at 1250% in accordance with CRR Article 89(3). It also excludes equity investments in funds which is treated under the approach for collective investment undertakings.

55. SA risk weights in the Basel 3.1 standards are applied to an exposure value that is measured net of specific provisions (as is generally the case under SA).

56. Article 128(2)(c) of the Standardised Approach and Internal Ratings Based Approach to Credit Risk (CRR) Part.

57. Article 128 of the Standardised Approach and Internal Ratings Based Approach to Credit Risk (CRR) Part.

58. See footnote 21 for the European Commission's proposal.

59. See footnote 21 for the European Commission's proposal.

Appendices

- Appendix 4: Draft PRA Rulebook (CRR) Instrument [2023] (PDF 4.1MB)
- Appendix 11: Draft amendments to Supervisory Statement SS10/13 – Credit Risk Standardised Approach' (PDF 1.5MB)
- Appendix 12: Draft amendments to Supervisory Statement 13/16 – Underwriting Standards for Buy-to-Let Mortgage Contracts (PDF 1.4MB)
- Appendix 14: Draft Supervisory Statement – Credit Risk Definition of Default (PDF 1.6MB)

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CP16/22 – Implementation of the Basel 3.1 standards: Credit risk – internal ratings based approach

Chapter 4 of CP16/22

Published on 30 November 2022

Content

Overview

4.1 This chapter sets out the Prudential Regulation Authority's (PRA) proposals to implement the Basel 3.1 standards for the internal ratings based (IRB) approach to credit risk. It also proposes amendments to the PRA's expectations in respect of the IRB approach and the definition of default used for both the IRB approach and the standardised approach (SA) to credit risk.

4.2 The proposals in this chapter would:

- complement HM Treasury's (HMT) proposed revocation of certain Capital Requirements Regulation (CRR) articles and associated technical standards;
- introduce a new Credit Risk: Internal Ratings Based Approach (CRR) Part of the PRA Rulebook relating to the IRB approach, to replace CRR articles and associated technical standards that HMT plans to revoke and a technical standard that the PRA proposes to remove;
- amend the existing Credit Risk Part of the PRA Rulebook;
- remove the existing Standardised Approach and Internal Ratings Based Approach to Credit Risk (CRR) Part of the PRA Rulebook (in so far as it relates to the IRB approach); and
- withdraw Supervisory Statement (SS) 11/13 'Internal Ratings Based (IRB) approaches' and introduce two SSs, namely: SS 'Internal Ratings Based Approach' (Appendix 13) and SS 'Definition of Default' (Appendix 14).

4.3 The IRB approach permits firms to use internal models as inputs for determining their regulatory risk-weighted assets (RWAs) for credit risk, subject to certain constraints. The Basel 3.1 standards introduce changes to the foundation internal ratings based (FIRB) approach and the advanced internal ratings based (AIRB) approach. The changes to the IRB approach are a key element of the Basel 3.1 package.

4.4 The Basel Committee on Banking Supervision's (BCBS) empirical analyses, conducted following the global financial crisis, highlighted a significant degree of variability in RWAs calculated using internal models. While there was a high degree of consistency in firms' assessments of the relative riskiness of obligors, the analysis identified material dispersion in the levels of estimated risk, as expressed in the probability of default (PD) and loss given default (LGD) that firms assigned to the same exposures.

4.5 Related to these findings, the BCBS also identified a number of other shortcomings in the IRB approach. These include excessive complexity, lack of comparability in firms' internally modelled IRB RWAs, and a lack of robustness in modelling certain exposure classes.[1] Together, these findings suggest that a 'one-size-fits-all' approach to modelling where firms can and should model all exposure classes is unlikely to be the most prudentially sound approach.

4.6 In response to this, the Basel 3.1 standards make changes to the IRB approach, including a number of complementary measures that aim to:

- reduce the complexity of the approaches and improve comparability across firms;
- address excessive variability across firms in the calculation of RWAs for credit risk; and
- restore the credibility of the IRB framework among market participants.

4.7 The PRA agrees with the concerns identified by the BCBS and therefore proposes changes to the existing IRB framework that address them. By doing so, the PRA considers that the proposals in this chapter would promote the safety and soundness of firms with IRB permissions, and would reduce barriers to effective competition between SA and IRB firms.

4.8 Specifically, consistent with the Basel 3.1 standards, the PRA proposals include:

- removing the option to use the IRB approach for certain categories of exposures and restricting modelling within the IRB approach for certain other categories of exposures where it is judged that the model parameters cannot be estimated reliably for regulatory capital purposes. As such, firms using the IRB approach would no longer be required to model all material exposure classes;
- adopting exposure-level, model parameter floors ('input floors') to help ensure a minimum level of conservatism for portfolios where the IRB approaches remain available; and
- providing greater specification of parameter estimation practices to reduce variability in RWAs for portfolios where the IRB approaches remain available.

4.9 The PRA also proposes changes to improve the operation of the elements of the IRB framework that do not derive from the Basel 3.1 standards. These include a proposal to change the threshold for approving IRB model applications and IRB model changes from 'full compliance' with the IRB requirements to 'material compliance'. The proposed new SS on the IRB approach would incorporate material from the existing SS11/13 as well as from the European Banking Authority's (EBA) Guidelines related to the IRB framework that the PRA has adopted. The PRA also proposes to make a number of changes to existing expectations to improve the overall consistency and coherence of the PRA's IRB framework. Where this chapter refers to existing expectations, this includes guidance currently located in EBA Guidelines as well as expectations currently located in SS11/13.

4.10 The proposals in this chapter are relevant to PRA-authorised banks, building societies, PRA-designated investment firms, and PRA-approved or PRA-designated financial holding companies or mixed financial holding companies ('firms'). The proposals would not apply to UK banks and building societies that meet the Simpler-regime criteria and choose to be subject to the Transitional Capital Regime proposals[2] except for the case where a firm in the Transitional Capital Regime wishes to apply for an IRB model approval.[3]

4.11 In this chapter, the PRA has set out details of its proposals where it proposes substantive changes to requirements and expectations relative to the existing approach. The PRA also proposes to make a number of other amendments in order to enhance the clarity and coherence of the framework. This includes consolidating some existing PRA rules into new Rulebook parts. To the extent that the PRA does not propose to amend the existing approach, existing requirements and expectations would continue to apply.

Implementation timelines

4.12 This section sets out the PRA's proposed timelines for implementing the changes to the IRB approach proposed in this chapter.

4.13 Implementation of the PRA's proposals relating to the IRB approach would require a number of changes to firms' IRB models. For some IRB models, the PRA recognises that the proposed changes would be in addition to other changes that need to be made in order to implement the PRA's IRB roadmap.[4] This is particularly the case for wholesale LGD and exposure at default (EAD) models, and for all unsecured retail models.

4.14 The PRA has previously communicated to firms with existing IRB permissions[5] that it would minimise the extent to which they have to redevelop models in order to implement the IRB roadmap, only to then have to redevelop the same models a second time to implement the proposals set out in this chapter. Consequently, the PRA has delayed IRB roadmap submission deadlines for those models that are most likely to be affected by the proposals set out in this chapter to help ensure a co-ordinated and proportionate approach, and to reduce the burden on firms.

4.15 The PRA noted in its previous communication that it would give firms a sufficient period after the publication of the 'near-final' policy statement (PS) related to the proposals set out in this chapter[6] to submit delayed IRB roadmap model changes to the PRA. All other non-delayed IRB roadmap model change applications are expected to be submitted to the PRA by H2 2022 and implemented in advance of the proposals set out in this chapter.[7]

4.16 Consistent with the above, the PRA therefore clarifies below its proposed approaches to the:

- changes to the IRB framework that would need to be in place by the PRA's proposed implementation date (see Chapter 1 – Overview);
- measures that would need to be in place where firms' IRB models are not fully compliant by the PRA's proposed implementation date; and
- timescales for IRB model submissions.

Changes required by the PRA's proposed implementation date

4.17 The PRA proposes that firms implement non-modelling related changes and input floors to model parameters by the PRA's proposed implementation date of 1 January 2025. The following changes would apply from this date:

- all restrictions on the scope of IRB models (eg restrictions on modelling EAD and mandatory use of the SA or FIRB approach, subject to the transitional arrangements for equity exposures);
- all changes to LGD and EAD under the FIRB approach and all changes to the maturity calculation; and
- all IRB input floors.

4.18 The PRA notes that the above non-modelling related changes would not need to be notified to the PRA under its notifications and approvals framework.

4.19 Firms' existing IRB permissions were issued under the CRR. The PRA expects these permissions to be saved by HMT to avoid firms needing to re-apply for existing permissions. The PRA would then vary these permissions using its powers under section 144G of the Financial Services and Markets Act 2000 (FSMA) where necessary such that the saved permissions would operate in line with the proposals set out in paragraph 4.17 from 1 January 2025.

4.20 The PRA considers that these changes would improve the robustness of modelled risk weights and their timely implementation would promote the safety and soundness of firms and improve competition between SA and IRB firms.

Requirements where firms are not fully compliant by the PRA's proposed implementation date

4.21 In contrast to the non-modelling changes, the PRA does not propose to require that the IRB models themselves be fully compliant at the proposed implementation date provided that:

- firms have an appropriate remediation plan in place that has been agreed with the PRA, including an appropriate date for the implementation of their new models, or demonstrate that the effect of the non-compliance is immaterial; and

- during this period, firms assess whether a post-model adjustment (PMA) is necessary in order to cover any shortfall in RWAs (further details about the proposals related to PMAs are provided in the section 'Calculation of risk-weighted assets (RWAs) and expected loss (EL)' in this chapter.

4.22 The above approach would apply in all cases of non-compliance, including in cases where the model submission deadlines communicated by the PRA (see paragraph 4.27) result in models that would not be approved by the PRA's proposed implementation date. This approach would be in line with the approach that the PRA previously took to address non-compliance with the hybrid mortgage and IRB roadmap requirements and expectations.[8]

4.23 The PRA proposes to apply this approach to the residual parts of IRB models that would be split as a result of implementing the proposals set out in this chapter (eg where some exposures currently within scope of an LGD model are moved to the FIRB approach, while some exposures remain on the AIRB approach).

4.24 The PRA considers that the proposed application of PMAs would help ensure that RWAs are prudent, while maintaining proportionality as the PRA considers that it would be difficult for firms to ensure that all models would be fully compliant at the proposed implementation date. The PRA considers that remediation plans should include a clear timetable to bring the model into compliance.

Timescales for model submission

4.25 The following considerations have been taken into account by the PRA in determining its proposals for the timescales for IRB model submissions:

- the desirability that IRB models are as compliant as soon as possible after the PRA's proposed implementation date;
- the time firms need to revise their IRB models following 'near-final' PS publication;
- the need to incentivise firms to begin model development work in a timely manner; and
- PRA resourcing considerations for reviewing model changes.

4.26 The PRA considers that firms would need a material amount of time between publication of the 'near final' PS and submission of the first set of model changes. In order to assist firms' model development planning, the PRA proposes that it would not expect any model changes required to implement the proposals set out in this chapter to be submitted to the PRA before 1 July 2024.

4.27 The PRA proposes to communicate firm-specific timetables for submitting tranches of model change applications following publication of the PRA's 'near-final' PS. This would align with the process used for the IRB roadmap where PRA supervisors communicated submission deadlines to individual firms in order to manage the flow of submissions to the PRA.

Question 16: Do you have any comments on the PRA's proposed implementation timelines?

PRA objectives analysis

4.28 The PRA considers that the proposed timelines would advance the PRA's primary objective of safety and soundness. The timelines would result in all IRB non-modelling changes being implemented by the PRA's proposed implementation date, which would improve the robustness and risk capture of the IRB approach. In cases where model changes are not made by that date, firms would be required to assess whether PMAs would be appropriate to address any potential undercapitalisation of risk.

4.29 The proposals support the PRA's secondary competition objective as the PRA considers that timely implementation of the IRB non-modelling changes would narrow the gap between SA and IRB approach risk weights. The proposed PMAs for model changes that are not in place by the PRA's proposed implementation date would achieve a similar outcome and also help level the playing field between firms using IRB that are compliant and those that are not compliant, as well as between incumbent IRB firms and new IRB applicants.

'Have regards' analysis

4.30 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Relevant international standards (FSMA CRR rules):

- The proposals would result in the PRA requesting model change applications from firms to implement the IRB model changes relating to the PRA's implementation of the Basel 3.1 standards as soon as reasonably possible. The proposal to require firms to develop a remediation plan and hold PMAs where necessary if they are not compliant would result in a level of capitalisation consistent with that required under the Basel 3.1 standards.

2. Relative standing of the UK as a place to operate (FSMA CRR rules) and competitiveness (HMT recommendation letters):

- The proposal to apply PMAs where firms are non-compliant and undercapitalised at the PRA's proposed implementation date would help ensure a level playing field with other jurisdictions that have implemented the Basel 3.1 standards and therefore supports the relative standing of the UK as a place to operate and its global competitiveness.

3. Finance to the real economy (FSMA CRR rules):

- The proposals would support the provision of finance to the real economy by mitigating the potential risk of disruption to firms' lending decisions if they were unable to continue using IRB models.

4. Proportionality (FSMA regulatory principles and Legislative and Regulatory Reform Act 2006):

- The PRA considers that the proposals set out in this section are a proportionate approach to the implementation of the proposals set out in this consultation paper (CP) and their interaction with other related changes to the IRB approach. The proposals recognise that firms would need time to update their IRB models to implement the proposed changes and, by aligning the timelines for implementation of such changes with those required for the IRB roadmap and by avoiding the need for firms to redevelop the same IRB models twice, the PRA aims to reduce the regulatory burden imposed on firms.

Permission to use the IRB approach

4.31 This section sets out the PRA's proposals relating to IRB permissions.

Standards for IRB application approval for new models

4.32 Under the CRR, the PRA approves applications for IRB permissions if, and only if, it considers that all the requirements in the IRB chapter of the CRR are fully met. As a result, firms must remediate any CRR non-compliance in an IRB model application before an IRB permission can be granted by the PRA, even if the effect of the non-compliance is immaterial.

4.33 The PRA considers that this is not proportionate and places firms seeking IRB approval ('IRB aspirants') at a competitive disadvantage relative to firms with IRB approval. This is because firms with existing IRB approvals are not currently required to remediate immaterial non-compliance. The PRA considers this to have a negative impact on competition among UK firms.

4.34 The PRA therefore proposes to change the threshold for approval of IRB permission applications from ‘full compliance’ to ‘material compliance’ with the PRA’s requirements. For this purpose:

- non-compliance would only be considered immaterial if it results in a minimal impact on the quantitative and qualitative aspects of the firm’s IRB approach; and
- the materiality of the non-compliance would be assessed at model level and in aggregate to help ensure that immaterial non-compliance across multiple models does not become material overall.

4.35 The PRA proposes that applications that are materially non-compliant would not be approved as it considers that this could adversely impact the safety and soundness of firms.

Standards for IRB application approval for material model changes

4.36 Under the CRR, the PRA approves applications for material extensions and changes to IRB models if, and only if, it considers that the application does not introduce any new non-compliance. This applies even if the application would remediate other existing non-compliance in a firm’s IRB approach. The PRA considers that this may prevent a firm replacing a non-compliant IRB model with a more compliant model that nonetheless incorporates some new immaterial non-compliance.

4.37 The PRA considers that greater overall model compliance is more prudent, so proposes to change the standards for approval for IRB model change applications from full compliance to material compliance in line with the proposed approach to new applications.

4.38 In addition, the PRA proposes to change the standard for approval of IRB model change applications such that they may be approved where materially non-compliant if:

- the application is for changes to existing models only (applications to adopt more sophisticated modelling approaches for subsets of exposures would not be in scope);[9]
- approval of the application would reduce the overall level of non-compliance in the firm’s IRB approach; and
- the firm has a plan in place to remediate the remaining material non-compliance within a reasonable time period.

4.39 The PRA considers that this proposed change would be beneficial as it would enable IRB model improvements to be implemented sooner by firms. However, the PRA continues to consider it important that firms seek to promptly remediate non-compliance and would retain the right to take supervisory action in respect of remaining non-compliance, in cases where it grants approval for a materially non-compliant IRB application, for a material model change.

Other proposals

4.40 The PRA currently expects an appropriate individual in a Senior Management Function (SMF) holder to provide to the PRA, on an annual basis, written attestation as to whether their firm's IRB models are compliant with CRR requirements and PRA SS expectations. The PRA also requests that firms submit an attestation of compliance when applying to make material model changes. See Appendix 13.

4.41 The PRA proposes to extend the annual attestation expectation so that it also covers compliance with PRA rules and covers implementation of an appropriate remediation plan where relevant. The PRA also proposes to introduce an explicit expectation that firms submitting applications and notifications relating to the IRB approach should provide the PRA with a self-assessment of whether it complies with relevant CRR requirements, PRA rules, and SS expectations. See Appendix 13.

4.42 The PRA also proposes to introduce a requirement that firms submit annually a list of their IRB models that are included within the scope of their IRB permissions. This would replace firm-specific requirements that apply to a number of IRB firms. See Credit Risk: Internal Ratings Based Approach (CRR) Part.

4.43 The PRA proposes to move the criteria for determining whether IRB model change applications require 'pre-approval', 'pre-notification', or 'post-notification' and associated documentation requirements (which are currently set out in regulatory technical standards)[10] into PRA rules. As part of this, the PRA also proposes to align documentation requirements for notifications with those for 'pre-approval' applications to better reflect existing practice, to make a number of amendments to the criteria to improve the clarity of the framework, and to align with other proposals set out in this CP. See Credit Risk: Internal Ratings Based Approach (CRR) Part.

4.44 The PRA proposes to align the approach for assessing the materiality of non-compliance which arises subsequent to an IRB permission approval being granted with the proposed approach for assessing the materiality of non-compliance for new IRB permission applications that is set out above. See Credit Risk: Internal Ratings Based Approach (CRR) Part.

4.45 The PRA's 'overseas models approach' (OMA) enables firms with overseas subsidiaries to use IRB models developed to non-UK standards and approved by local regulators to be used for calculating UK consolidated capital requirements when certain criteria are met. One of these criteria is that the exposures within the scope of the model must be located in an equivalent jurisdiction as determined by CRR Article 142(2). The PRA proposes to link the concept of an equivalent jurisdiction instead to CRR Article 114(7) given that it is proposed that CRR Article 142(2) would be revoked by HMT and not replaced in PRA rules. See Credit Risk: Internal Ratings Based Approach (CRR) Part.

4.46 The PRA proposes to introduce a specific permission for use of the OMA and to introduce a savings provision so that firms with existing permission to use OMA models need not reapply. The PRA also proposes to transfer the majority of existing expectations regarding use of the OMA approach to PRA rules as requirements on firms. See Credit Risk: Internal Ratings Based Approach (CRR) Part.

> **Question 17: Do you have any comments on the PRA's proposals for permission to use the IRB approach?**

PRA objectives analysis

4.47 The PRA considers that the proposed approach to granting permissions for IRB models would advance the PRA's primary objective of promoting the safety and soundness of firms. The proposals would facilitate the timely remediation of existing non-compliance by enabling firms to replace non-compliant IRB models that may be a threat to safety and soundness with IRB models that, despite themselves being non-compliant, are more likely to ensure that firms' RWAs better capture risk. In addition, the PRA considers that permitting immaterial non-compliance at the point of model approval would not be likely to have an adverse impact on safety and soundness.

4.48 The PRA considers that the proposals in this section would facilitate effective competition. The proposal that IRB model applications need to be materially compliant, instead of fully compliant, should promote a more level playing field between IRB firms and IRB aspirants, as firms with IRB approval are not currently required to remediate immaterial non-compliance. The proposals would also reduce the barriers to entry to using the IRB approach.

'Have regards' analysis

4.49 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Sustainable growth (FSMA regulatory principles and HMT recommendation letters):

- The PRA's proposals to change the test for IRB model approval to 'materially compliant' would support sustainable growth as the PRA considers that firms which have the capability to apply the IRB approach would be able to implement it in a timelier manner.

This additional flexibility should support sustainable growth to the extent IRB risk weights more accurately reflect the risk of exposures than SA risk weights.

2. Relative standing of the UK as a place to operate (FSMA CRR rules) and competitiveness (HMT recommendation letters):

- The proposal to change the test for IRB model approvals to 'materially compliant' should permit greater flexibility than the existing PRA approach and enhance the international competitiveness of the UK. Firms would be able to adopt the IRB approach in a timelier manner, enabling them to benefit from more risk-sensitive RWAs once they have sufficient modelling capabilities.

3. Relevant international standards (FSMA CRR Rules):

- The PRA considers that its proposed approach is broadly aligned with international standards. The PRA considers that its proposal to change the standard for approval of IRB model applications and model changes from full compliance to material compliance is not explicitly contemplated in the Basel 3.1 standards. However, given the PRA proposes that only immaterial non-compliance would be permitted, it considers the impact on alignment with the Basel 3.1 standards would be immaterial.

4. Efficient and economic use of PRA resources (FSMA regulatory principles):

- The PRA's proposals to change the test for model approvals to 'materially compliant' would reduce the amount of resource that the PRA needs to deploy to assess immaterial issues.

5. Proportionality (FSMA regulatory principles and Legislative and Regulatory Reform Act 2006):

- The proposals set out in this section are a proportionate response to non-compliance in IRB model applications. The proposals would enable the PRA to reach decisions on model applications more quickly and could reduce the number of model changes required by firms, while continuing to help ensure that models are robust.

IRB exposure classes and sub-classes

4.50 This section sets out the PRA's proposals on IRB exposure classes and sub-classes.

4.51 The PRA has reviewed the existing IRB exposure classes and proposes a small number of definitional changes. The PRA also proposes to introduce new exposure sub-classes in some cases to bring greater clarity to the regulatory framework. There are instances where firms are required to apply different treatments to different categories of exposures within an exposure class. The introduction of exposure sub-classes would enable these requirements to be set out more clearly.

Central governments and central banks exposure class

4.52 The PRA proposes to restrict the scope of the 'central governments and central banks' exposure class to only include exposures to central governments and central banks. Under the CRR, some exposures to regional governments and local authorities, public sector entities (PSEs), multilateral development banks (MDBs), and international organisations can be assigned to this exposure class. The PRA proposes that these would be assigned to the 'institutions' exposure class instead.

4.53 The PRA considers that this proposal aligns the scope of this exposure class with the set of central government and central bank exposures which the PRA proposes would move to the SA as set out in the section 'Restrictions on IRB modelling' below.

Institutions exposure class

4.54 The PRA proposes to introduce two exposure sub-classes within the 'institutions' exposure class:

- 'Quasi-sovereigns' – this would include all exposures to regional governments and local authorities, PSEs, MDBs, as well as international organisations that are assigned a 0% risk weight under the SA.
- 'Other institutions' – this would include exposures to institutions and exposures treated as institutions under the SA.

Corporate exposure class

4.55 The PRA proposes to introduce three exposure sub-classes within the 'corporate' exposure class in order to align with the scope of the proposed approaches for modelling corporate exposures:

- 'Specialised lending' – this would include exposures to corporates that meet the definition of specialised lending. The PRA proposes to amend this definition to insert a condition that the borrowing entity has little or no other material assets or activities. Therefore, it would have little or no independent capacity to repay the obligation, apart from the income that it receives from the asset(s) being financed. The PRA proposes this change to align with the definition set out in the Basel 3.1 standards.
- 'Financial corporates and large corporates' – this would include all exposures to financial sector entities (FSEs), as defined in CRR Article 4(1)(27), that fall within the corporate exposure class (financial corporates), and all other exposures to corporates with total

consolidated annual revenues greater than £440 million,[11] measured over a rolling average over the prior three years based on accounting consolidated data (large corporates).

- 'Other general corporates' – this would include all other corporate exposures.

Retail exposure class

4.56 The PRA proposes to introduce three exposure sub-classes within the 'retail' exposure class to align with the exposure sub-classes set out in the Basel 3.1 standards:

- 'Qualifying revolving retail exposures' (QRRE);
- 'Retail exposures secured by residential immovable property'; and
- 'Other retail'.

4.57 Currently, exposures to small and medium-sized enterprises (SMEs) can only be included in the retail exposure class if the total exposure to the obligor and related entities (excluding exposures secured by residential immovable property), not including undrawn amounts, does not exceed €1 million. The PRA proposes to amend this criterion so that exposures to SMEs would only be included in the 'retail' exposure class if the total exposure, including any undrawn limit, to the obligor and related entities (excluding exposures secured on residential property) does not exceed £0.88 million.[12] The PRA considers that its proposed inclusion of undrawn limits in the threshold would align better with the Basel 3.1 standards and reduce the likelihood that exposures are reclassified when facilities are drawn down and repaid.

Equity exposure class

4.58 The PRA proposes that exposures in the form of units or shares in collective investment units (CIUs) would be allocated to a separate sub-class within the 'equity' exposure class. The PRA also proposes to align the scope of the remainder of the 'equity' exposure class with those exposures that are treated as equity under the SA.

4.59 The PRA therefore proposes to introduce the following two exposure sub-classes within the equity exposure class which would align with the scope of the proposed approaches to risk-weighting these exposures:

- 'Units or shares in CIUs'; and
- 'Other equity'.

> **Question 18: Do you have any comments on the PRA's proposed IRB exposure classes and sub-classes?**

PRA objectives analysis

4.60 The PRA considers that the proposals to amend the IRB exposure classes and sub-classes are consistent with its primary objective of safety and soundness. The proposed change to the definition of SMEs would likely result in an increase in RWAs for some SME exposures to the extent that the existing definition fails to adequately capture the risk attached to undrawn credit facilities. The remaining proposals would not directly impact RWAs. Where different modelling approaches would be applied to different exposure classes or sub-classes, this is assessed in the relevant section of this CP.

4.61 The PRA considers that the proposals in this chapter are consistent with its secondary objective of facilitating effective competition. The proposals would result in more consistent allocation of exposures to exposure classes across firms, which should reduce unwarranted variation in RWAs across firms.

'Have regards' analysis

4.62 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Proportionality of costs and benefits (FSMA regulatory principles and Legislative and Regulatory Reform Act 2006):

- The proposals in this chapter would create costs for firms initially, to the extent that they would need to adjust internal systems to reflect revised exposure class and exposure sub-class definitions. However, the PRA considers that these costs would not persist over time. The PRA considers that firms would benefit from a clearer exposition of requirements, which would justify any increase in costs.

2. Relevant international standards (FSMA CRR rules):

- The PRA considers that some of its proposed changes, such as the proposed revision to the scope of the 'central governments and central banks' exposure class, would result in some minor differences in how exposures are categorised relative to the Basel 3.1 standards. The PRA considers; however, that the proposed changes are desirable as they would result in exposures with more similar characteristics being grouped together.

3. Efficient and economic use of PRA resources (FSMA regulatory principles):

- Greater clarity regarding the exposures contained in each exposure class would result in more efficient use of PRA resources in assessing the appropriateness of firms' allocation of exposures.

Restrictions on IRB modelling

4.63 This section sets out the PRA's proposals to implement the restrictions placed on modelling under the IRB approach in the Basel 3.1 standards.

4.64 The BCBS identified concerns regarding the extent to which certain exposure classes, particularly those containing low default portfolios, can be modelled robustly for the calculation of RWAs. These exposure classes share similar characteristics, including insufficient data for the estimation of key risk inputs, a lack of information possessed by firms, insufficient comparative advantage of firms relative to regulators in assessing the risk of such exposures, and/or the lack of robust, generally accepted, and validated modelling techniques.

4.65 The PRA shares the concerns identified by the BCBS. The PRA also considers that some of the concerns identified by the BCBS apply to central government and central bank exposures. These concerns, as covered below in the 'Roll-out, permanent partial use, and reversion' section of this chapter, led the BCBS to conclude that firms do not need to either model all material exposure classes, or none of them (ie modelling should no longer be 'all or nothing').

4.66 In response to these concerns, the PRA proposes to introduce a number of restrictions on modelling risk weights, consistent with the Basel 3.1 standards, as set out in the paragraphs below.

Removal of IRB for central government and central bank exposures

4.67 Central government and central banks exposures can currently be modelled using either the FIRB or AIRB approach. While the Basel 3.1 standards do not introduce restrictions on modelling these exposures, the PRA considers that firms also face considerable challenges in modelling this exposure class.

4.68 Specifically, the PRA considers that some of the BCBS's concerns regarding low default portfolios also apply to central government and central bank exposures, including a lack of modellability and an insufficient comparative advantage of firms relative to regulators in assessing the risk. The PRA also considers that UK firms have historically had difficulty building robust central government and central bank IRB models.

4.69 The PRA therefore proposes to prohibit modelling of central government and central bank exposures under IRB, and to require all central government and central bank exposures to be risk-weighted under the SA (see Chapter 3 – Credit risk – Standardised approach for the proposed SA approach for sovereign exposures).[13] The PRA considers that removing modelling of central government and central bank exposures would increase the consistency and comparability of risk weights for these exposures and facilitate effective competition.

4.70 The PRA recognises that firms could choose to continue to use central government and central bank IRB models for risk management purposes even if they are no longer permitted to be used for calculating regulatory RWAs.

Removal of the advanced IRB approach for exposures to institutions, financial corporates, and large corporates

4.71 Currently, RWAs for exposures to institutions, financial corporates, and large corporates can be modelled using either the FIRB or AIRB approaches. The Basel 3.1 standards remove the use of the AIRB approach for risk-weighting these exposures and, as a result, the FIRB approach is the only modelling approach that remains available. The BCBS concluded that this was justified based on the identified challenges in modelling LGD and EAD for these exposure classes and related concerns with the robustness of these models, as set out above.

4.72 The PRA shares the BCBS's concerns and proposes to remove the AIRB approach for the following exposures:

- exposures to institutions and financial corporates, where financial corporates would comprise other financial sector entities (FSEs), as defined in CRR Article 4(1)(27); and
- exposures to large corporates, where the exposures are not classified as specialised lending. Modelling of exposures to corporates that are not large corporates, including exposures to SMEs, would still be permitted.[14]

4.73 The existing definition of FSEs includes ancillary services undertakings and holding companies; therefore, the PRA's proposal would remove the AIRB approach from a wider set of exposures than is envisaged by the Basel 3.1 standards. However, firms are currently required to use the definition of FSEs to determine whether a 1.25 multiplication factor applies to the co-efficient of correlation parameter in the IRB approach risk weight formula, and the PRA considers that using a common definition to restrict AIRB modelling would reduce the implementation burden for firms. In addition, the PRA considers the additional exposures brought in scope by the wider definition would generally sit within low default portfolios, therefore supporting the PRA's concerns regarding modellability.

4.74 In the section titled 'IRB exposure classes and sub-classes' above, the PRA proposes to expand the institutions exposure class to include regional governments and local authorities, PSEs, MDBs, and international organisation exposures that are assigned a 0% risk weight under the SA that currently fall within the 'central governments and central banks' exposure class. As the PRA proposes to remove AIRB modelling for exposures to institutions, the combined effect of these proposals would be that the AIRB approach would be removed for all exposures to regional and local governments, PSEs, MDBs, and international organisations that are assigned a 0% risk weight under SA. The PRA considers that this is appropriate due to the difficulty of modelling LGD and EAD for these exposures.

Removal of the IRB approach for equity exposures

4.75 There are currently three IRB methodologies for calculating RWAs for equity exposures: the 'simple risk weight' approach, the 'PD / LGD' approach, and the 'internal models approach'. Under the simple risk weight approach, firms apply prescribed risk weights to different categories of equity exposures while the other two approaches involve some modelling.

4.76 The Basel 3.1 standards prohibit the modelling of equity exposures and withdraw all three IRB methodologies for equity exposures on the basis that such exposures cannot be modelled in a robust and prudent manner. The BCBS noted that, for many equity exposures, it is unlikely that firms would have specific knowledge concerning the issuers compared with that found in publicly available data. Additionally, the IRB approach for equities only applies to exposures in the banking book, and such exposures tend to only form a very small component of firms' balance sheets. Furthermore, from a competition perspective, in cases where firms are using the IRB simple risk weight approach to risk weight equity exposures, there is little justification for different SA and IRB prescribed risk weights for the same exposures. As a result, the SA is the only credit risk approach remaining in the Basel 3.1 standards for risk-weighting equity exposures.

4.77 The PRA shares these concerns and proposes to remove the IRB approach for equity exposures and require RWAs for all equity exposures to be calculated using the SA.[15] The PRA considers that this should improve the robustness, simplicity, consistency, and comparability of the RWAs for equity exposures.

Transitional arrangements

4.78 The Basel 3.1 standards allow a five-year linear phase-in arrangement for firms using the IRB approach to move equity exposures to the SA, in order to give firms additional time to adjust to the revised approach. The PRA proposes to introduce transitional arrangements that are in line with the Basel 3.1 standards.

4.79 The PRA proposes two transitional approaches for equities: the SA transitional approach outlined in Chapter 3 and the IRB transitional approach outlined in this section. Together, the two proposed transitional arrangements are intended to facilitate a smooth change to the new SA equity risk weights by firms to avoid unnecessary volatility in RWAs.

The PRA proposes that firms would apply the IRB transitional approach for all equity exposures subject to the IRB approach on 31 December 2024 and apply the SA transitional approach for all other exposures.

4.80 The PRA proposes to introduce a five-year IRB transitional period from the PRA's proposed implementation date of 1 January 2025. Under the proposed IRB transitional approach, firms would, for each individual equity exposure, apply the higher of:

- the risk weight for the exposure calculated under the CRR (based on the firm's IRB permission as of 31 December 2024); and
- the risk weight for the exposure calculated under the SA transitional approach (as outlined in Chapter 3).

4.81 In order to avoid excessive complexity in the capital framework, the PRA proposes that firms would calculate exposure values using the SA methodology (ie net of provisions) for the duration of the transition. The PRA does not propose that firms would be required to calculate any 'expected loss' (EL) amounts in respect of exposures subject to the IRB transitional approach.

4.82 The PRA recognises that the proposed transitional arrangements could nevertheless still result in some volatility in RWAs which it considers would be undesirable. To mitigate this risk, the PRA proposes to allow firms the option to 'opt-out' of the IRB equity transitional arrangements entirely and to move to the final SA risk weights for all equity exposures at any point before or during the transitional period by notifying the PRA. The PRA proposes that in these circumstances firms would not be able to revert back to the transitional arrangements.

4.83 Where firms apply the look-through or mandate-based approach for risk-weighting CIUs, they need to determine the risk weights of the underlying exposures. As an exception, where a firm is using the IRB approach, but equity exposures underlying a CIU are subject to the SA via a permanent partial use permission, the simple risk weight approach is used to determine the risk weights of the underlying equity exposures instead.

4.84 The PRA proposes that firms using the IRB transitional approach for equity would, when determining the risk weight of an equity exposure that would have been subject to the SA prior to the start of the equity transitional period, calculate the applicable risk weight as if the exposure had been subject to the simple risk weight approach prior to the start of the equity transitional period. This is to reduce undesirable volatility in risk weights arising from the introduction of the proposed transitional arrangements.

Question 19: Do you have any comments on the PRA's proposed restrictions on the use of the IRB approach?

PRA objectives analysis

4.85 The PRA considers that the proposals relating to the removal of the AIRB approach for financial institutions and large corporate exposures would advance its primary objective. The PRA considers that the lack of default data for these exposures indicates that firms are typically unable to robustly model LGD and EAD. As a result, removing modelling of these parameters would promote safety and soundness by improving the robustness of, and reducing unwarranted variability in, RWAs.

4.86 Similarly, the PRA considers that its proposal to remove modelling of central government, central bank, and equity exposures would be consistent with the principle that firms should be permitted to model exposures only where they can do so in a robust manner. However, as noted in Chapter 3, the PRA has concerns that proposed SA risk weights for exposures to central governments and central banks can potentially result in an underestimation of RWAs. Such undercapitalisation can stem from the 0% risk weight applied to highly rated central government and central bank exposures, and the equivalence-based risk weight overrides. The PRA therefore intends to consult in the future, as part of the wider Pillar 2 review discussed in Chapter 10 – Interactions with the PRA’s Pillar 2 framework, on a potential Pillar 2 methodology to help ensure the adequate capitalisation of these exposures.

4.87 The PRA considers that the proposals set out in this section would advance its secondary competition objective. The proposed restrictions on modelling would apply to all firms using the IRB approach and, as a result, RWAs should be more comparable across firms for the same exposure. In the case of exposures to institutions, financial corporates, and large corporates, the PRA considers that the proposals would improve competition between those firms currently using the FIRB approach for these exposures and those currently using the AIRB approach.

4.88 The PRA considers that the proposal to remove modelling of central government, central bank, and equity exposures would also advance its secondary competition objective as all firms would risk weight these exposures under the SA, resulting in less variation in approaches across firms.

‘Have regards’ analysis

4.89 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government’s economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA’s analysis of the proposals:

1. Sustainable growth (FSMA regulatory principles):

- The PRA assesses that the proposals in this section would have little adverse impact on sustainable growth. There is some potential that the proposed removal of the AIRB approach for exposures to institutions, financial corporates, and large corporates could increase RWAs and reduce incentives for firms to lend, although the PRA considers this would depend on the conservatism of firms' existing modelled LGD and EAD estimates. The PRA considers that where RWAs do increase, this would benefit sustainable growth to the extent that RWAs currently fail to adequately capture risk. This is because the PRA considers that adequate capitalisation of the risks of these low default portfolios is essential for sustainable lending and therefore sustainable growth.

2. Relevant international standards (FSMA CRR rules):

- The PRA considers that the proposed removal of the AIRB approach for institutions, financial corporates, and large corporates, and the proposed removal of all IRB approaches for equities, would be aligned with the Basel 3.1 standards. The PRA considers that the proposal to remove all IRB approaches for central government and central bank exposures would also be aligned with international standards as the Basel 3.1 standards envisage that national supervisors may choose not to implement all available modelling approaches.

3. Competitiveness (HMT recommendation letters) and relative standing of the UK as a place to operate (FSMA CRR rules):

- The PRA considers that the proposals in this section would not adversely impact the competitiveness of the UK. The proposals relating to institutions, financial corporates, large corporates, and equity exposures are likely to be in line with the approach taken by other major jurisdictions. The PRA considers that the proposal to remove modelling entirely for exposures to central governments and central banks would likely result in lower RWAs for some exposures and higher RWAs for other exposures relative to those jurisdictions that retain the IRB approach. However, as the PRA considers that it is unlikely that overall RWAs would increase as a result of the proposals in this section, it does not consider there would be any adverse impact on competitiveness.

Roll-out, permanent partial use, and reversion

4.90 This section sets out the PRA's proposals on roll-out, permanent partial use, and reversion to less sophisticated approaches.

4.91 Firms' existing permissions for roll-out and permanent partial use were issued under the CRR. The PRA expects these permissions to be saved by HMT. The PRA would then vary these permissions using its powers under section 144G of FSMA where necessary, such that the scope of saved permissions would be restricted so that they are consistent with the proposals set out in this section. Firms would then treat any non-compliance in line with the approach set out in paragraph 4.21 and would be able to apply to extend the scope of existing permissions in line with the proposals set out in this section.

Roll-out and permanent partial use of SA by roll-out class

4.92 Firms are currently required to roll-out the IRB approach across all exposures once they have obtained an IRB permission. However, there are exceptions under certain circumstances. For example, an exception is made for 'exposures in non-significant business units as well as exposure classes or types of exposures that are immaterial in terms of size and perceived risk profile'.[16]

4.93 This 'full use' requirement can act as a barrier to adoption of the IRB approach. The Basel 3.1 standards remove the 'full use' requirement and instead allow firms to adopt IRB for some exposure classes while allowing other exposure classes to remain permanently on the SA.

4.94 The PRA proposes to broadly align with the Basel 3.1 standards. It also proposes to withdraw its existing expectation regarding the maximum proportion of a firm's RWAs that may remain on the SA when an IRB permission is in place, which would enable firms to depart from the full use requirement. The PRA considers; however, that it is important to avoid creating 'cherry-picking' opportunities where firms are able to optimise RWAs through their choice of which exposures should remain on the SA. Therefore, the PRA proposes to introduce a number of safeguards to mitigate this risk.

4.95 The PRA proposes to define a set of eight 'roll-out classes' for which firms are able to apply for permission to permanently use the SA. Where firms obtain this permission, they would be allowed to roll-out the IRB approach to some roll-out classes but apply the SA to others. The PRA proposes to introduce the following set of roll-out classes, which the PRA considers is broadly aligned with the Basel 3.1 standards:

- 'institutions';
- 'specialised lending';
- 'corporate purchased receivables';
- 'general and financial corporates';
- 'qualifying revolving retail exposures';
- 'retail exposures secured on residential immovable property';

- ‘retail purchased receivables’; and
- ‘other retail’.

4.96 Further detail on the proposed roll-out classes, and the interaction with the proposed exposure classes and sub-classes in the ‘IRB exposure classes and sub-classes’ section, is set out in the table below.

Table 1: Proposed roll-out classes

Roll-out class	Definition
a. institutions	Exposures in the institutions exposure class
b. specialised lending	Exposures in the specialised lending exposure sub-class
c. corporate purchased receivables	Exposures to purchased receivables within the corporates exposure class
d. general and financial corporates	Exposures in the financial corporates and large corporates and the other general corporates exposure sub-classes, excluding purchased receivables
e. qualifying revolving retail exposures	Exposures in the qualifying revolving retail exposures exposure sub-class
f. retail exposures secured on residential immovable property	Exposures in the retail exposures secured by residential property exposure sub-class
g. retail purchased receivables	Exposures to purchased receivables within the retail exposures exposure class
h. other retail	Exposures in the other retail exposure sub-class, excluding purchased receivables

4.97 In order to mitigate the risk of ‘cherry-picking’, the PRA proposes to introduce a requirement that a firm should not permanently use the SA for a roll-out class if this would result in significantly lower credit risk RWAs than under the IRB approach unless:

- the firm cannot reasonably model exposures in the roll-out class; or

- the roll-out class is immaterial.

4.98 The PRA proposes that, for this purpose, 'significantly lower credit risk RWAs' would mean that SA RWAs are reasonably estimated to be less than 95% of group credit risk IRB RWAs for that roll-out class, prior to application of the proposed output floor.

4.99 The PRA also proposes to specify the following criteria to determine circumstances in which the PRA considers firms could not reasonably model exposures in a roll-out class, namely that either:

- the firm would not have sufficient data to model exposures in the roll-out class, nor could the firm be reasonably expected to obtain sufficient data in a timely manner, and that the deficiency in data did not arise due to historic non-compliance with the data collection and storage requirements in the CRR or in BIPRU;[17]
- the firm could not reasonably develop a compliant modelling approach due to the nature and complexity of the exposures in the roll-out class; or
- the use of the IRB approach for the roll-out class would not result in significant improvements in risk differentiation or risk quantification than if the SA were applied to that roll-out class.

4.100 The PRA proposes to specify that a roll-out class would be considered immaterial if total SA RWAs for the roll-out class do not exceed 5% of total group credit risk RWAs, prior to application of the proposed output floor.

4.101 The PRA has observed historically that SA RWAs for the QRRE and specialised lending roll-out classes could be materially lower than those calculated using the IRB approach. The PRA also considers that firms would typically be able to develop a compliant IRB approach for these roll-out classes (including the slotting approach for specialised lending exposures). As such, the PRA proposes to introduce an expectation, to supplement the proposed requirements, that firms with an IRB permission for any roll-out class should not permanently apply the SA for either the QRRE roll-out class or the specialised lending roll-out class unless the roll-out class in question is immaterial.

Permanent partial use of the SA within roll-out classes

4.102 As set out above, the Basel 3.1 standards no longer contain a full use requirement for adopting IRB across roll-out classes. However, the Basel 3.1 standards have introduced a requirement that once IRB has been rolled out to a roll-out class, IRB would be adopted for all exposures within that roll-out class, subject to a materiality exemption.

4.103 The PRA considers that to require firms to apply the IRB approach to immaterial exposures and to require firms to model RWAs for exposures where they lack the capability would be disproportionate and undesirable. The PRA therefore proposes that firms should be able to apply for permission to permanently apply the SA to subsets of exposures within a roll-out class. The PRA proposes however that this would only be permitted in the following cases:

a. the firm is unable to model the type of exposure;

b. the exposures are immaterial;

c. the exposures are to institutions relating to Bank of England minimum reserve requirements and certain other conditions (maintaining the CRR Article 150(1)(i) exemption); or

d. intragroup exposures meeting certain conditions (maintaining the CRR Article 150(1)(e) exemption).

4.104 For (a), the PRA proposes to apply the same criteria to determine that firms are unable to model a type of exposure within a roll-out class as those proposed for determining whether firms can model entire roll-out classes.

4.105 For (b), the PRA proposes to limit the exposures within a roll-out class that could be treated as immaterial to 5% of the total group credit risk RWAs for that roll-out class prior to application of the proposed output floor. The PRA considers this requirement would limit opportunities for 'cherry-picking' risk-weighting approaches.

4.106 The PRA has also considered whether to retain other existing CRR permanent partial use exemptions. The PRA considers that the majority of the existing exemptions are either no longer relevant, due to other changes in the framework such as restrictions on the scope of modelling; or no longer necessary, due to the proposed introduction of a more general exemption for immateriality as set out in (b) above. The PRA therefore proposes to remove these exemptions. The PRA proposes; however, to retain the exemptions currently in the CRR relating to intragroup exposures and exposures in the form of minimum reserves required by the Bank of England.

4.107 The PRA considers that to introduce an overall upper limit on the permanent partial use of the SA within a roll-out class is appropriate to limit 'cherry-picking' opportunities and to help ensure that a critical mass of exposures are modelled within roll-out classes for which firms adopt IRB. The PRA proposes to set this limit at 50% of total group credit risk RWAs for the roll-out class. Given the specific nature of exemptions (c) and (d), the PRA does not propose to restrict use of these exemptions. RWAs for these exposures would therefore be excluded from both the numerator and denominator in the calculation of the 50% RWA threshold.

Permanent partial use of the FIRB approach

4.108 There are currently no restrictions on the permanent partial use of the FIRB approach, except where firms wish to revert to a less sophisticated approach. As a result, there is a potential risk that firms may engage in 'cherry-picking' and select portfolios to remain on the FIRB approach in order to lower their RWAs.

4.109 The PRA considers it desirable to limit 'cherry-picking' opportunities for those exposures where both the FIRB and the AIRB approaches are available. The PRA therefore proposes that firms applying the AIRB approach for any of these exposures would need to apply to the PRA for permission to apply the FIRB approach to such exposures, and that use of the FIRB approach in these circumstances would not be permitted where the change is proposed to lower RWAs relative to applying the AIRB approach. The PRA proposes to create a 'non-retail AIRB modelling roll-out category' of exposures in its rules, which would consist of all exposure sub-classes that are eligible for both the FIRB and the AIRB approaches and that would be subject to these proposed restrictions.

Reversion to less sophisticated credit risk approaches

4.110 Firms are currently only able to revert to less sophisticated approaches (either from the IRB approach to the SA or from the AIRB approach to the FIRB approach) if they have permission from the PRA and the proposed reversion:

- is not proposed in order to reduce the RWAs of the firm;
- is necessary on the basis of the nature and complexity of the firm's total exposures of this type; and
- would not have a material adverse impact on the solvency of the firm or its ability to manage risk effectively.

4.111 The Basel 3.1 standards contain a general provision that firms already using the IRB approach for an exposure class would continue to do so after implementing the Basel 3.1 standards, but it also permits reversion to less sophisticated approaches in 'extraordinary circumstances'. The PRA considers that to implement a specific 'extraordinary circumstances' condition is unnecessary, and therefore proposes to retain the existing conditions for reversion and apply these to both entire roll-out classes and subsets of exposures within roll-out classes.

4.112 However, the PRA considers that one-off costs that relate to implementing the proposed requirements set out in this CP could occur and that, as a result, mandating firms to remain on either the FIRB approach or the AIRB approach could be unduly burdensome. Therefore, the PRA proposes to supplement the reversion conditions with expectations that it would consider one-off costs arising from implementing the requirements proposed in this CP as a relevant factor when it considers whether the conditions are met.

4.113 The PRA also proposes to clarify that firms using the AIRB or the FIRB approaches for specialised lending exposures could only adopt the slotting approach where they have the permission of the PRA and their proposed implementation of the slotting approach is materially compliant with the PRA's requirements.

> **Question 20: Do you have any comments on the PRA's proposed approach to roll-out, permanent partial use, and reversion?**

PRA objectives analysis

4.114 The PRA considers that the proposals on roll-out and reversion advance its primary objective, as they are designed to reduce the prudential risk associated with firms 'cherry-picking' risk-weighting approaches in order to reduce RWAs without a corresponding reduction in risk. The PRA considers that the proposals would also advance safety and soundness by not requiring firms to model exposures for which they are unable to develop robust models.

4.115 The PRA also considers its proposals for partial use of the SA by roll-out class would also advance the PRA's secondary competition objective. The proposals could reduce the barriers to entry for smaller firms adopting the IRB approach by no longer requiring firms to roll-out the IRB approach to all exposures. The PRA's proposed conditions for permanent partial use of the SA by roll-out class may result in some barriers to entry remaining as some firms may still need to model certain roll-out classes; for example, QRRE. However, the PRA considers the benefits to its primary objective from applying these conditions justify any resultant negative impacts on its secondary competition objective.

'Have regards' analysis

4.116 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Sustainable growth (FSMA regulatory principles) and growth (HMT recommendation letters):

- The PRA considers that the proposals in this section would not adversely impact sustainable growth. The PRA considers that providing firms with greater flexibility to determine which portfolios could have RWAs calculated using internal models would enable firms to adopt the IRB approach in a more timely manner for those portfolios for which modelling approaches remain. The PRA considers the proposals would enable the firms to calculate more risk-sensitive RWAs and help ensure that RWAs do not fall to an imprudent level as a result of cherry-picking between risk-weighting approaches. The PRA considers that this would support sustainable growth.

2. Relevant international standards (FSMA CRR rules):

- The PRA considers that the proposals on roll-out and reversion are broadly in line with the Basel 3.1 standards, as the PRA's proposed approach is stricter in some respects and provides more flexibility in others. The PRA proposes to introduce more stringent anti-cherry-picking measures in order to address the PRA's concerns regarding the relative risk weights of certain exposures under the SA compared to under the IRB approach, such as for QRRE and specialised lending exposures, which could result in potentially inadequate RWAs at the aggregate level. The PRA also proposes to implement greater flexibility for firms to apply the SA to certain exposures within a roll-out class that is subject to IRB. Therefore, on balance, the PRA considers that its proposals are aligned with international standards.

Calculation of risk-weighted assets (RWAs) and expected loss (EL)

4.117 This section sets out the PRA's proposals for the calculation of RWAs and EL.

The 1.06 scaling factor

4.118 Under the existing Basel standards and the CRR, the formula used to calculate IRB RWAs includes a scaling factor of 1.06 for non-defaulted exposures. This was included by the BCBS when the IRB approach was first introduced and was intended to maintain the aggregate level of minimum capital requirements compared to the previous Basel standards.

4.119 The Basel 3.1 standards remove the 1.06 scaling factor on the basis that it is no longer necessary given the enhancements to the IRB framework and the introduction of an aggregate output floor. The PRA shares the BCBS's view and considers that, given the other changes the PRA proposes to implement in this CP, the 1.06 scaling factor is no longer required and proposes to remove the 1.06 scaling factor from the IRB formula.

The 1.25 asset value co-efficient of correlation multiplier

4.120 The CRR requires firms to apply a 1.25 multiplier (the 'multiplier') to the co-efficient of correlation in the IRB RWA function for exposures to 'large financial sector entities' and 'unregulated financial sector entities'. The application of the multiplier results in higher RWAs for these exposures and is intended to capture the systemic risk associated with exposures to these entities.

4.121 The following definitions are currently used in the CRR:

- Large financial sector entities are defined as any financial sector entity (FSE) with total individual or consolidated assets greater than or equal to €70 billion (based on financial statements) where the entity (or one of its subsidiaries) is subject to UK prudential regulation or equivalent third-country prudential regulation.
- Unregulated financial sector entities are defined as entities that are unregulated but which perform one or more activities specified under The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 as their main business.

4.122 The PRA considers that the scope and application of the CRR requirements lack clarity in places.

4.123 The first shortcoming relates to the treatment of regulated third-country FSEs. While the CRR is clear on the treatment of regulated third-country FSEs that are equivalently regulated, the CRR does not explicitly set out the treatment of regulated third-country FSEs that are not equivalently regulated. In particular, the PRA considers that the exemption from the multiplier for large FSEs not subject to equivalent regulation is inappropriate as exposures to large FSEs not subject to equivalent regulation would have lower RWAs than would be the case if they were equivalently regulated. The PRA considers that exposures to large FSEs pose a systemic risk regardless of how they are regulated.

4.124 The PRA consequently proposes to extend the scope of application of the multiplier to all large FSEs, regardless of the nature of the regulation they are subject to. The PRA considers that this amendment would provide clarity to firms on the application of the multiplier, correct the counter-intuitive treatment in which non-equivalently regulated FSEs attract lower risk weights, and advance the PRA's primary objective of safety and soundness.

4.125 The second shortcoming relates to the calculation of the €70 billion asset threshold in the large FSE definition. The CRR states that the €70 billion threshold is calculated on an individual or a consolidated basis. However, an EBA '**Q&A'** issued while the UK was a member of the EU stated that only the assets of the entity and its subsidiaries should be considered, rather than the assets of the wider group.

4.126 The PRA considers that the CRR approach is potentially imprudent and could incentivise regulatory arbitrage. The PRA considers that systemic risks could arise from large groups as well as large entities. While measuring asset size based only on an entity, its parent company, and its subsidiaries, not taking the wider group into account, meets the explicit requirements of the Basel 3.1 standards, the PRA considers that this approach does not sufficiently reduce risks arising from the interconnectedness of large financial institutions, which is the purpose of the multiplier. The PRA therefore proposes to amend the CRR definition of large FSEs to explicitly include the total assets of the entire group. The PRA would continue to require firms to calculate total assets based on accounting assets.

4.127 The PRA considers that an additional benefit of this proposal is that it would reduce the potential for regulatory arbitrage. Such arbitrage could occur if firms choose to lend to specific subsidiaries within a group, in order to avoid the application of the multiplier and apply preferential risk weights to the same or very similar risk. In addition, groups could themselves transfer businesses into smaller subsidiaries to facilitate arbitrage or increase the number of parent entities in the group to avoid classification as a large FSE.

4.128 The third shortcoming relates to the definition of unregulated FSEs. The PRA considers that limiting the scope of unregulated FSEs to entities that are not subject to any regulation would result in the exclusion of entities only subject to limited prudential regulation from the requirements (eg financial intermediaries), which the PRA considers inconsistent with the Basel 3.1 standards.

4.129 The PRA therefore proposes to amend the definition of an unregulated FSE to include all FSEs that are not prudentially regulated as either a credit institution, investment firm, or an insurer. The PRA considers that this approach would result in the multiplier being applied to a set of FSEs that is consistent with those envisaged by the Basel 3.1 standards. The PRA also considers that the proposed approach would be simpler for firms to operationalise.

4.130 The PRA notes that the FSE threshold in the CRR is €70 billion and this corresponds to $100 billion in the Basel 3.1 standards. The PRA proposes in Chapter 13 – Currency redenomination, to redenominate the $100 billion threshold in the Basel 3.1 standards to £79 billion.

> **Question 21: Do you have any comments on the PRA's proposals relating to the 1.06 scaling factor and to the 1.25 asset value co-efficient of correlation multiplier?**

SME support factor

4.131 As noted in Chapter 3, the CRR SME support factor was originally introduced to limit disruption to the flow of credit to small businesses during the phase-in of stricter requirements following the global financial crisis. For exposures to businesses with a turnover below €50 million and total borrowings (excluding residential property) not exceeding €1.5 million, a support factor equal to 0.7619 is applied to Pillar 1 RWAs. This calibration was designed to broadly offset the additional capital required for the capital conservation buffer.

4.132 The SME support factor applies to all credit risk exposures included in the retail, corporate or secured by mortgages on immovable property exposure classes that satisfy the criteria in CRR Article 501 (exposures in default are excluded). It applies to the SA and IRB approaches. It was identified as a material deviation from the Basel standards in the 2014 **BCBS Regulatory Consistency Assessment Programme (RCAP) report** on the EU implementation of Basel standards.

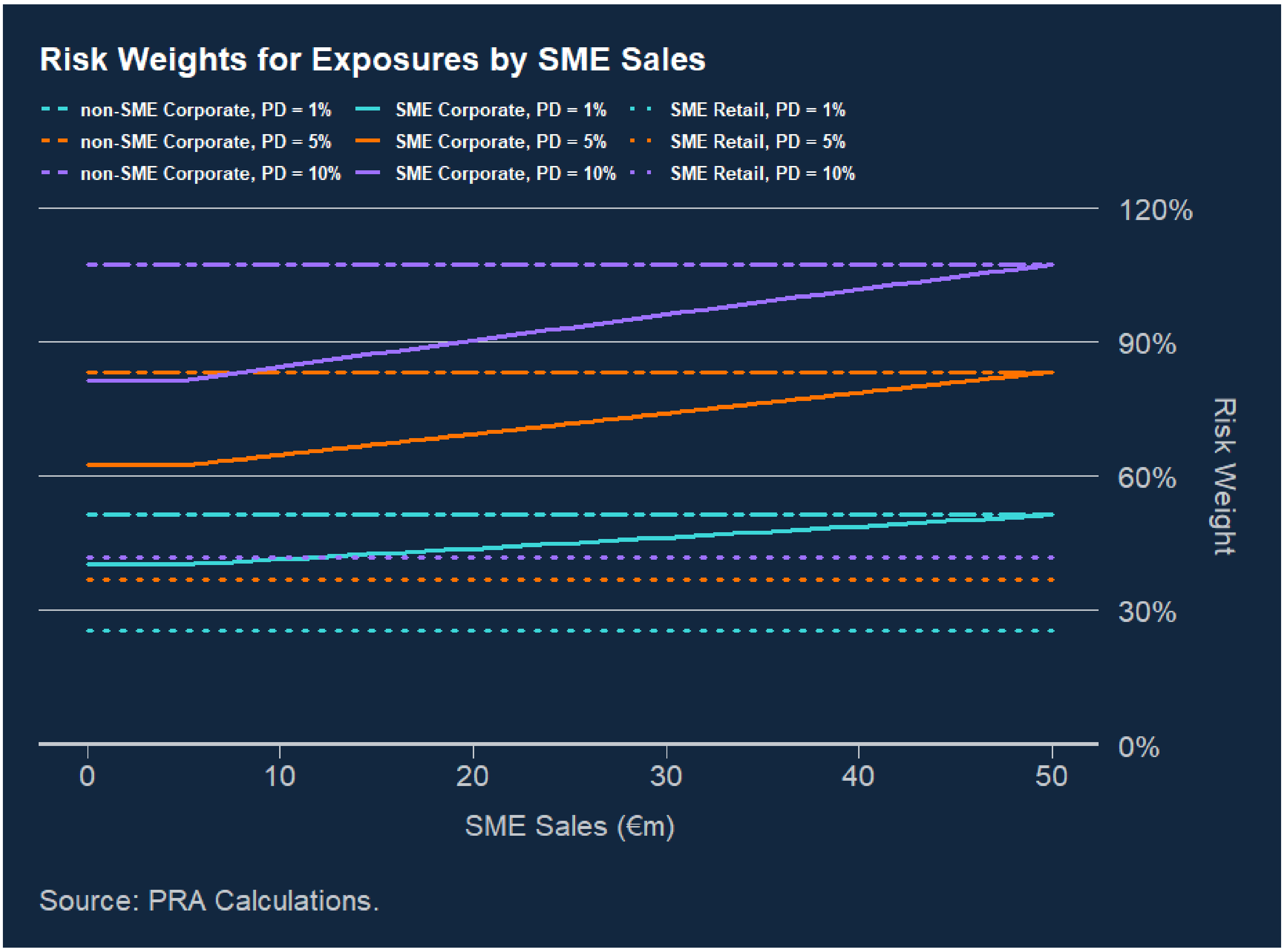
4.133 CRR II expanded the scope of the SME support factor. The ceiling on total borrowings (excluding residential property) has been raised to €2.5 million, and a new support factor of 0.85 is now applied to any lending exceeding this threshold. These changes were onshored when the UK left the EU.

4.134 As set out in Chapter 3, the PRA has considered existing analysis on the effectiveness of the SME support factor and, while the PRA recognises that conceptually the SME support factor could be a stimulus for supporting sustainable lending to SMEs, the available evidence is inconclusive at a system level. **EBA analysis** concluded that the SME support factor could be imprudent, is not risk-based, and had not materially supported lending to SMEs.

4.135 The PRA considers that the risk weight treatment for SMEs under the IRB approach should already be appropriate without the support factor for the following reasons:

- IRB modelled risk weights should already be risk-sensitive and reflect a firm's historic experience of lending to SME counterparties;
- the IRB corporate risk weight formula already includes a firm-size adjustment (an adjustment to the co-efficient of correlation) for exposures to SME obligors, which reduces the applicable risk weight for SME exposures relative to other corporate exposures (see Chart 1 below); and
- exposures to SMEs that qualify for the IRB retail exposure class are risk-weighted using the retail IRB risk weight formula rather than the corporate IRB risk weight formula which produces lower risk weights for retail SME exposures than for corporate exposures (see Chart 1 below).

Chart 1: Comparison of risk weights for retail SME, corporate SME, and non-SME corporate exposures[18]



4.136 Therefore, the PRA considers that modelled IRB risk weights for SME exposures should reflect the risk and that a further discount on the risk weights is not justified based on the evidence the PRA has available. It therefore proposes to remove the SME support factor.

4.137 However, the PRA considers it appropriate, in proposing to remove the support factor, to consider whether the IRB approach is appropriately calibrated for SME exposures, both the firm-size adjustment in the corporate IRB formula for corporate SME exposures and the retail IRB formula for retail SME exposures. The PRA would welcome feedback, including quantitative or qualitative evidence across a range of economic conditions, on whether the IRB approach would appropriately reflect the risk of SME exposures if the support factor is removed.

Question 22: Do you have any comments on the PRA's proposal to remove the SME support factor under the IRB approach? Do you have any evidence – quantitative or qualitative – regarding the appropriateness of the IRB approach for SME exposures in the absence of the support factor?

Infrastructure support factor

4.138 As noted in the Chapter 3, the CRR infrastructure support factor allows firms to apply a 0.75 multiplier to RWAs for certain exposures that are allocated to the corporate exposure class or specialised lending exposure class. Defaulted exposures are excluded and the criteria in CRR Article 501a must be satisfied in order to apply it. The infrastructure support factor applies to exposures under the SA and the IRB approach.

4.139 The PRA proposes to not apply the infrastructure support factor under the IRB approach. In cases where a firm models risk weights for exposures that would currently qualify for application of the support factor, the modelled risk weights should be risk-sensitive and reflect the firm's historic experience of lending to that type of exposure. For exposures that would currently qualify for the support factor that are assigned to the specialised lending exposure class and are risk-weighted using the slotting approach, the criteria for assigning exposures to slots would allow firms to take into account the specific risk characteristics of each exposure and result in risk-sensitive risk weights being assigned to the exposures. Therefore, the PRA considers that IRB risk weights for exposures qualifying for the infrastructure support factor should reflect the risk, and a further discount on the risk weights is not justified on the basis of the evidence the PRA has available. It therefore proposes to remove the infrastructure support factor.

4.140 However, similar to the above proposal for the SME support factor, the PRA considers it appropriate as part of its proposal to remove the infrastructure support factor to consider whether the IRB modelling approach and the slotting approach for infrastructure exposures are appropriately calibrated. It therefore particularly invites firms to present quantitative or qualitative evidence on this topic during the consultation.

Question 23: Do you have any comments on the PRA's proposal to remove the infrastructure support factor under the IRB approach? Do you have any evidence – quantitative or qualitative – relating to the appropriateness of the IRB approach for infrastructure exposures in the absence of the support factor?

Treatment of expected loss amounts

4.141 Under the CRR, firms using the IRB approach are currently required to compare the total amount of eligible provisions (including various adjustments) (P) with the total EL amount. Where the EL amount exceeds P, firms must deduct the difference from CET1 capital. Conversely, where P is greater than the EL amount, firms may recognise the difference in Tier 2 capital (subject to a limit of 0.6% of IRB RWAs). Additionally, if specific provisions are greater than the EL amount for defaulted exposures, the difference cannot be used to cover EL amounts for non-defaulted exposures.

4.142 The PRA considers that the CRR currently lacks clarity as to whether excesses of specific provisions over EL amounts for defaulted exposures can be added to Tier 2 capital if they are not used to cover EL amounts for non-defaulted exposures. The PRA considers that adding these amounts to Tier 2 capital would be consistent with the objectives of the regulatory framework.

4.143 The PRA therefore proposes to introduce new formula for comparing P and EL amounts in PRA rules. The effect of the formulae would be that:

a. if (a) specific provisions for defaulted exposures are greater than the EL amount for defaulted exposures, and (b) the EL amount for non-defaulted exposures is greater than all other provisions, then:

- the difference in specific provisions over the EL amount for defaulted exposures may be included in Tier 2 capital (subject to the existing limit); and
- the difference in the EL amount for non-defaulted exposures over other provisions would be deducted from CET1 capital;

b. in all other cases:

- if P is greater than the EL amount, the difference may be added to Tier 2 capital (subject to the existing limit); and
- if the EL amount is greater than P, the difference would be deducted from CET1 capital.

4.144 The PRA considers that the proposed formulae would continue to help ensure that specific provisions for defaulted exposures cannot be used to cover EL amounts on other exposures. While this is not required by the Basel 3.1 standards, the PRA considers there is sufficient prudential justification for doing so.

Unrecognised exposure adjustment

4.145 The PRA currently would expect that firms using the AIRB approach should, where material, calculate RWAs on a portfolio basis (rather than at an exposure level) to reflect products or relationships that are not intended to result in a credit exposure, but where there is an exposure at default (EAD) nonetheless ('adjustment for non-credit relationships and facilities'). An example of these products are current accounts without an overdraft facility that are nonetheless permitted to be overdrawn.

4.146 The PRA considers that some of the proposals set out in this CP would mean that this expectation is not sufficiently broad. In particular:

- The PRA proposes to define commitment under both the SA and IRB approach as any off-balance sheet contractual arrangement that has been offered by the firm and accepted by the obligor, including to extend credit, purchase assets, or issue credit substitutions (but which is not an issued off-balance sheet item). This could result in certain facilities that have an EAD falling outside the scope of the risk weight framework. These exposures may not be captured by the adjustment for non-credit relationships and facilities as currently defined; and

- The PRA proposes to significantly reduce the scope of exposures for which EAD could be modelled. The existing adjustment for non-credit relationships and facilities only applies where firms are applying the AIRB approach and modelling EAD. The result could be that this adjustment would potentially capture significantly fewer exposures going forward based on its existing scope.

4.147 In addition, there is currently ambiguity regarding how firms should reflect the existing adjustment for non-credit relationships and facilities, resulting in a lack of clarity and coherence in the regulatory framework.

4.148 In order to address the above considerations, the PRA proposes to remove the existing expectation and introduce a new requirement that firms using any of the IRB approaches would calculate an 'unrecognised exposure adjustment'. The proposal would not require firms to calculate an unrecognised exposure adjustment where the amount of such exposures is immaterial.

4.149 The PRA's rationale for making this proposal is to capture amounts outstanding at default arising from facilities or relationships that are not captured in exposure value measures. Outstanding amounts would not be otherwise captured because either (a) they were not intended to result in credit exposures, or (b) they are not classified as off-balance sheet items.

4.150 The proposed adjustment would be implemented as an RWA adjustment at the portfolio level applying to firms using any of the IRB approaches, regardless of whether EAD is modelled, and would aim to capture all credit exposure not otherwise captured by the IRB framework.

4.151 The PRA recognises that this proposal is additional to the Basel 3.1 standards. However, the PRA considers that to remove its existing expectations without a proposal for a more appropriate approach would result in a less prudent framework than is currently in place. The PRA considers that it is prudentially important that all exposures that would arise in the event of default are captured in IRB RWAs to help ensure that firms' RWAs reflect the risks associated with all types of potential exposures.

Adjustment to RWAs for UK residential mortgage exposures in the retail exposure class

4.152 The PRA currently has an expectation that firms apply a 10% exposure-weighted average portfolio risk-weight floor to UK retail residential mortgage exposures in order to reflect risks that may not be fully captured by firms' IRB models.

4.153 The PRA considers that attributing this floor the same status as other proposed floors would improve the coherence of the regulatory framework. The PRA therefore proposes to require firms to apply a 10% exposure-weighted average portfolio risk-weight floor to UK retail residential mortgage exposures through a PRA rule.

Post-model adjustments

4.154 The PRA currently has an expectation that firms address identified IRB model issues in a timely fashion with suitable model changes and that these changes are implemented in accordance with the appropriate model changes process. However, the PRA recognises that there are instances where it is prudent and correct for firms to adjust the RWAs produced by their models on a temporary basis through a post-model adjustment (PMA).

4.155 The PRA considers that to improve the coherence of the regulatory framework, PMAs should have the same status as the other proposals set out in this section relating to RWA and EL adjustments.

4.156 Where non-compliance with modelling standards results in a material understatement of RWAs and/or EL amounts for a particular IRB model, the PRA proposes to require firms to quantify and implement PMAs as an adjustment to RWAs and EL amounts through a PRA Rule.

4.157 The relevant detail about how firms calculate PMAs would continue to be set out in an SS. The PRA proposes to clarify that PMAs should be assessed following the application of all relevant floors.

Other minor change

4.158 As set out in Chapter 13, the PRA has proposed a methodology for redenominating certain references to Euros (EUR) and US Dollars (USD) into Pound Sterling (GBP) in the PRA rules proposed in this CP.

4.159 Two references to EUR that the PRA proposes to redenominate are currently in CRR Article 153(4). These are the maximum and minimum annual sales thresholds to be used in the firm size adjustment in the IRB formula for the corporate exposure class. The PRA proposes to replace the values currently in EUR in the formula to the GBP converted values as set out in Chapter 13. See Credit Risk: Internal Ratings Based Approach (CRR) Part.

4.160 In addition to this, the PRA also proposes to calculate the difference between these converted thresholds, 39.6, and substitute this for 45 in the IRB formula for the corporate exposure class. This is to help ensure that the formula does not become inconsistent as a result of the PRA's proposed currency redenomination. See Credit Risk: Internal Ratings Based Approach (CRR) Part.

> **Question 24: Do you have any comments on the PRA's proposed approach to calculation of risk-weighted assets and expected loss, not covered by the questions above?**

PRA objectives analysis

4.161 The PRA considers that the proposals set out in this section would advance the PRA's primary objective of safety and soundness. The proposals aim to reduce the prudential risk associated with firms' IRB models not adequately reflecting risks and therefore resulting in underestimation of RWAs and EL. In particular, the proposed removal of the SME support factor and infrastructure support factor would help ensure RWAs for qualifying exposures are robust and not subject to potential underestimation. The proposal to remove the 1.06 scaling factor would mechanistically reduce IRB risk weights but the PRA considers this is prudentially justified on the basis that the scaling factor is no longer necessary given the proposed enhancements to the IRB framework and the introduction of an aggregate output floor. The other proposals in this section provide greater clarity on existing requirements and expectations, but in most cases do not represent a significant change to the existing approach.

4.162 The PRA considers that the proposals set out in this section would facilitate effective competition by ensuring that there is an appropriate level of conservatism in IRB modelled RWAs, therefore maintaining a more level playing field with firms that use the SA. The PRA proposes to remove the SME support factor and the infrastructure support factor under both the SA and the IRB approach, which it considers would facilitate effective competition between firms using the SA and firms using the IRB approach, particularly in light of the other proposed changes impacting the SA treatment of SME and project finance exposures set out in Chapter 3, which reduce the conservatism of the underlying SA risk weights.

'Have regards' analysis

4.163 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA),

the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Growth (HMT recommendation letters), finance for the real economy (FSMA CRR rules), and sustainable growth (FSMA regulatory principles):

- The PRA does not expect the proposals set out in this section to adversely impact sustainable financing or growth. Some of the proposals in this section would increase RWAs, while others would result in lower RWAs. The PRA considers that the proposed changes would improve the risk-sensitivity of RWAs, which would benefit sustainable growth to the extent that RWAs are inappropriately calibrated in some areas.

2. Relevant international standards (FSMA CRR rules):

- The PRA considers that the proposals set out in this section are broadly aligned with the Basel 3.1 standards. The PRA notes that its proposals relating to the asset value co-efficient of correlation multiplier potentially diverge from the Basel 3.1 standards. The PRA proposes to define FSEs as unregulated if they are not prudentially regulated as a credit institution, investment firm, or an insurer, whereas the Basel 3.1 standards imply that entities would be treated as unregulated if they are not subject to prudential requirements consistent with international norms. However, the PRA considers that the increase in clarity and reduction of inconsistencies between the definitions of a FSE and an unregulated FSE is prudentially justified, and is less complex for firms to operationalise. The proposed removal of the SME support factor and the infrastructure support factor would remove existing CRR deviations from the Basel standards and align with the Basel 3.1 standards.

3. Relative standing of the UK as a place to operate (FSMA CRR rules) and competitiveness (HMT recommendation letters):

- The PRA considers its proposal to remove the 1.06 scaling factor would help ensure risk weights are appropriate for the risk and contribute to the relative standing of the UK as a place to operate. The PRA would expect other jurisdictions to implement this change.
- The PRA considers its proposals for the SME support factor and infrastructure support factor would improve safety and soundness, are aligned with the Basel 3.1 standards, and the PRA would expect them to be aligned with the approaches proposed by most other jurisdictions (which currently do not apply the support factors). The PRA understands that the European Commission proposes to retain the SME support factor and the infrastructure support factor, and considers this could have an impact on the UK's competitiveness in the short-term.

- While acknowledging there could be some short-term impact without further adjustment to the IRB approach, the PRA considers that the overall proposals in this section would not materially impact the relative standing of the UK as a place for internationally active credit institutions and investment firms to operate. The proposed removal of the SME support factor and the infrastructure support factor could be perceived to negatively impact the UK's relative standing, as it weakens a direct subsidy to lending. However, the PRA considers that IRB RWAs for SME and infrastructure exposures under its proposals would be risk-sensitive and appropriate to the risk firms are taking on, which would support UK competitiveness in the medium- to long-term. Additionally, the PRA considers that SME lending is predominantly undertaken within national markets, with limited cross-border lending. The PRA also observes that firms with IRB permissions are currently making limited use of the infrastructure support factor given difficulties in assessing the scope of eligible exposures. This reduces the potential impact of its proposed removal.

4. Efficient and economic use of PRA resources (FSMA regulatory principles):

- The PRA considers that while additional supervisory resources may be required in the short- to medium-term to monitor the implementation of the proposed new requirements in this section, the incremental increase in resource required would likely be immaterial.

General requirements for use of the IRB Approach

4.164 This section sets out the PRA's proposals relating to general requirements for use of the IRB approach.

Minimum data requirements for parameter estimation

4.165 The Basel 3.1 standards set minimum data requirements for firms to adopt the IRB approach. These state that firms should use at least five years of data from at least one source to estimate all parameters, with the exception of LGD and EAD for non-retail portfolios where seven years of data is required.

4.166 UK firms are currently subject to a five-year minimum data requirement for all parameters, including LGD and EAD for non-retail portfolios, which can be met with internal, external, or pooled data. Firms are also expected to use data from a representative mix of good and bad economic periods to calibrate PD and data from downturn periods to calibrate LGD and EAD. The PRA does not propose to make any substantive changes to this approach.

4.167 However, the PRA proposes to make two minor amendments to its data requirements in order to better align with the Basel 3.1 standards and which the PRA considers removes complexity in its rules. The amendments which the PRA proposes are to:

- clarify in its rules that data from a representative mix of good and bad economic periods form part of the minimum data requirements for modelling PD; and
- remove CRR provisions, which the PRA considers redundant in practice, that enable firms to apply for permission to reduce the minimum data requirements from five years to two years for retail exposures, and for non-retail exposures under the FIRB approach, for up to 5% of a firm's total credit risk exposures.[19]

4.168 In respect of the first proposal, the PRA currently expects PD estimates to reflect a representative mix of good and bad periods so that no additional data would be required in practice. The PRA proposes that this expectation becomes a PRA rule (as set out in the section 'Probability of default (PD) estimation' below), as it considers that to add a complementary minimum data requirement would increase the coherence of the regulatory framework. The PRA proposes that firms would continue to be permitted to use internal, external, or pooled data to meet the proposed new requirement.

4.169 In respect of the second proposal, the PRA notes that firms with limited internal data could use external or pooled data to meet the minimum five-year data requirement. As a result, the PRA considers that there is no need for these firms to apply to the PRA to reduce minimum data requirements and the PRA considers that the application process has become obsolete in practice. The PRA considers that this would be consistent with its broader aim of removing redundant complexity wherever possible.

4.170 The PRA would not expect that either of these proposals would adversely impact the ability of firms to adopt the IRB approach and would not expect that either proposal would have any impact on the facilitation of effective competition.

Data requirements and maintenance

4.171 The PRA proposes to make a number of amendments to its existing approach to data requirements and maintenance under the IRB approach. The PRA considers that these proposed amendments would improve the quality of data used in IRB models and would therefore advance its safety and soundness objective.

4.172 The PRA proposes to introduce more specific requirements for the collection and storage of:

- key borrower and facility characteristics;
- realised default rates;
- the components of loss for defaulted exposures; and
- the process of allocating exposures to grades or pools for retail exposures.

4.173 The PRA also proposes to introduce a requirement that firms submit an annual model inventory to the PRA. This proposal would replace existing requirements to submit model inventories where these have been applied to individual firms under s55M FSMA.

4.174 The PRA considers that its proposals would result in prudent and proportionate data standards, and that its proposals align with the Basel 3.1 standards. The PRA considers these changes would enhance clarity in the regulatory framework and would facilitate a consistent approach to collecting and storing of data among firms. This would enhance the PRA's ability to effectively supervise firms.

IRB model governance and validation

4.175 In relation to standards for IRB model governance and validation, the PRA proposes to:

- require that senior management would approve all material differences between established procedures and actual practice for parameter rating and estimation processes;
- clarify that the firm's management body or a designated committee thereof would be solely responsible for approving all material aspects of a firm's rating and estimation processes;
- introduce more specific requirements for the summary reports that would need to be produced by the firm's credit risk control unit (eg relating to historic default data and grade migration);
- explicitly require internal audit functions to document their findings;
- clarify an existing requirement relating to the consistency of quantitative validation through time by requiring that the methods and data used by firms should not vary systematically with the economic cycle; and
- add an expectation that firms take steps to remediate any deficiencies in the quality of the data used, or in their processes for maintenance of the data, in a timely manner.

4.176 The PRA considers that the proposals on IRB model governance and validation align with the Basel 3.1 standards, and the PRA considers that the proposals do so in a proportionate way that would increase clarity for firms.

Other proposed changes

4.177 The PRA proposes to remove an existing expectation that the rank-ordering of the IRB rating system should be exactly the same as the rank-ordering of the rating system used for internal risk management purposes. The PRA instead proposes to align with the Basel 3.1 standards and set an expectation that the rank-ordering of the IRB rating system should play an essential role in the rank-ordering used for internal risk management and decision-making purposes. The PRA considers this would remove an unnecessary barrier to firms' ability to access the IRB framework and would therefore advance the PRA's secondary objective of facilitating effective competition. See Appendix 13.

4.178 The PRA proposes to make two further minor changes to the framework as follows:

- to permit firms to apply a zero margin of conservatism in respect of the general estimation error where they can demonstrate that the general estimation error is immaterial. See Appendix 13; and
- to withdraw the existing provision that firms need not give equal importance to historic data if more recent data is a better predictor of loss rates or drawdowns. The PRA considers that this change would help ensure coherence and alignment with the Basel 3.1 standards.

> **Question 25: Do you have any comments on the PRA's proposed general requirements for the use of the IRB approach?**

PRA objectives analysis

4.179 The PRA considers that the proposals set out in this section would advance the PRA's safety and soundness objective by ensuring that firms are subject to robust standards on the quality of data, data processes, and governance of IRB models.

4.180 The PRA considers the proposed additional data requirements would not be onerous for firms to implement and therefore considers that these would not have a detrimental impact on the facilitation of effective competition. By providing additional detail on what the PRA would expect with regards to data, processes, and governance of IRB models, the PRA considers that firms would be more likely to take consistent approaches, rather than potentially taking different interpretations of less detailed requirements. The PRA considers that this may help support a level playing field across firms and promote competition. The PRA considers that effective competition would be further promoted by its proposal to revise its existing expectation relating to rank-ordering of rating systems, as this would improve accessibility to the IRB framework.

'Have regards' analysis

4.181 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA),

the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Proportionality (FSMA regulatory principles and Legislative and Regulatory Reform Act 2006):

- The PRA would expect that the potential additional costs some firms could incur to help ensure data is stored and maintained in line with the proposals would be low and proportionate to the benefits of firms having sufficiently robust data.

2. Efficient and economic use of the PRA's resources (FSMA regulatory principles):

- The PRA considers that by providing more detail on what it expects to be included in data, processes, and governance for IRB models, it would be able to process applications and conduct reviews of existing IRB models more efficiently. This is because it is more likely that the PRA would not have to use its resources to request additional information from firms.

3. Competitiveness (HMT recommendation letters):

- The PRA considers that the proposals set out in this section would increase external confidence in the quality of firms' IRB models and enhance the ability of the PRA to assess the safety and soundness of firms. The PRA considers this would support the attractiveness of the UK's financial market.

4. Relevant international standards (FSMA CRR rules):

- The PRA considers that the proposed changes set out in this section align with the Basel 3.1 standards.

5. Senior management responsibility (FSMA regulatory principles):

- The PRA has considered the impact of the proposals set out in this section on the responsibilities of senior management and considers that it is desirable to make the proposed clarifications in order to clearly set out the PRA's expectations.

Definition of default

4.182 This section sets out the PRA's proposals relating to the definition of default and is relevant to firms using the SA and the IRB approach.

4.183 The PRA's existing expectations relating to the definition of default are set out in SS10/13 for firms using the SA and SS11/13 for firms using the IRB approach. These SSs include an expectation that firms should comply with the EBA Guidelines on the definition of default (EBA/GL/2016/07).

4.184 The PRA proposes to issue a new SS on the definition of default, which would replace existing material in SS10/13 and SS11/13 as well as the EBA Guidelines. The proposed new SS (see Appendix 14) would contain all existing expectations relating to the definition of default with the exception of material that the PRA proposes to move to PRA rules as set out below. The PRA proposes to make a number of minor changes to these expectations that are either consequential on other proposed changes or are considered to enhance the coherence and clarity of the regulatory framework.

4.185 The PRA proposes to move the following expectations relating to the definition of default to the PRA Rulebook to become formal requirements for firms:

- expectations relating to the ability for firms applying the SA to treat exposures as retail exposures for the purpose of applying the definition of default;
- certain provisions relating to the circumstances in which the counting of days past due could be suspended;
- the specific treatment for exposures to central governments, local authorities, and PSEs, which would enable firms to treat exposures relating to the supply of goods and services as non-defaulted for up to 180 days past due in certain circumstances. The scope of this treatment would continue to be limited and would not extend to bonds issued by such entities;
- the period over which defaulted exposures remain classified as being in default once the triggers of default cease to apply; and
- the definition of distressed restructuring, including clarifying the definition of forbearance according to which a distressed restructuring is considered to have occurred. This would align the concept of forbearance used with that set out in the CRR.

4.186 The PRA proposes to make a number of further minor amendments to the PRA rules relating to days past due, including:

- removing references to a PRA discretion to permit use of a 180 days past due criteria and instead requiring firms to use a 90 days past due criteria in line with existing PRA expectations;
- relocating PRA rules relating to the application of the materiality threshold for the counting days past due so they are located alongside other rules within the PRA Rulebook relating to the definition of default; and

- applying the materiality threshold for retail exposures to all exposures that meet the SA retail criteria where a firm applies the SA approach, including where it has an IRB permission for other exposures.

4.187 The PRA proposes to set an expectation to clarify that exposures should be classed as being in default where a trigger of default applies, regardless of any credit risk mitigation technique used. In particular, the PRA proposes to clarify that firms using the IRB approach and applying the 'parameter substitution method' described in Chapter 5 – Credit risk mitigation should class defaulted exposures that are guaranteed by an entity that is not in default as being in default for the purpose of the 'EL – P' calculation.

Question 26: Do you have any comments on the PRA's proposed approach to the definition of default?

PRA objectives analysis

4.188 The PRA considers that the proposals set out in this section would advance the PRA's primary objective of safety and soundness by enhancing the clarity and coherence of requirements and expectations relating to the definition of default.

4.189 The PRA considers that the proposals set out in this section are consistent with its secondary objective of facilitating effective competition as the PRA proposes to apply broadly consistent requirements and expectations to firms using the SA and the IRB approach.

'Have regards' analysis

4.190 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Relevant international standards (FSMA CRR rules):

- The PRA considers its proposals are materially aligned with the Basel 3.1 standards.

2. Competitiveness (HMT recommendation letters) and relative standing of the UK as a place to operate (FSMA CRR rules):

- The PRA expects other jurisdictions to apply similar approaches, and therefore does not consider that the proposals set out in this section would adversely impact the competitiveness of the UK.

Input floors

PD, LGD, and EAD input floors

4.191 This section sets out the PRA's proposed approach to introduce PD, LGD, and EAD input floors.

4.192 As previously noted, the BCBS has identified excessive complexity in IRB approaches and the resultant modelled RWAs were found to lack robustness, consistency, and comparability across firms. As a means to address this, the Basel 3.1 standards introduce exposure-level floors for firm estimated IRB parameters that are used as inputs to the calculation of modelled RWAs ('input floors'). These include PD floors for the FIRB and the AIRB approaches, and LGD and EAD floors for the AIRB approach. In some cases, these floors consist of recalibrated values of floors in the existing Basel standards. In other cases, the floors represent new constraints on firms' IRB models.

4.193 The PRA considers these input floors are an important backstop for improving comparability, reducing unwanted variability, and reducing the cyclicality of modelled RWAs. The PRA considers that application of the floors would help ensure a minimum level of prudence, in particular for low default portfolios where data are limited, in the cases where modelling of such portfolios continues to be permitted.

4.194 The PRA therefore proposes to introduce PD, LGD, and conversion factor (CF)[20] input floors as set out below. The proposed floors would align with the calibration in the Basel 3.1 standards, except for the proposed UK retail residential mortgage PD floor, for which the PRA proposes a modestly higher floor than in the Basel 3.1 standards.

4.195 The proposed floors are designed and calibrated to reflect the riskiness of the respective exposure classes as well as firms' ability to robustly model different exposure classes. In determining the proposed floors, the PRA has sought to achieve an appropriate balance between ensuring the robustness of estimates while maintaining risk-sensitivity of models and to avoid creating incentives for firms to reduce investment in modelling capability or to increase the risk of their lending portfolio in order to reduce the impact of the floors.

4.196 The proposed PD floors would apply to all exposures capitalised under the IRB approach (except for exposures subject to the slotting approach), and the LGD and CF floors would apply to exposures to which the AIRB approach is applied (the CF floors would not apply where CF modelling is not permitted). The input floors would apply to non-defaulted and defaulted exposures but would not apply for the purpose of calculating 'best estimate of expected loss'.

PD input floors

4.197 The PRA proposes to introduce the following PD input floors:

- a 0.1% PD floor for UK retail residential mortgage exposures and for QRREs categorised as transactors; and
- a 0.05% PD floor for all other exposures.

4.198 The PRA's proposed 0.1% PD floor for UK retail residential mortgage exposures, which is somewhat more conservative than the 0.05% PD floor in the Basel 3.1 standards, would reflect the PRA's longstanding concern that some IRB UK retail residential mortgage risk weights have been falling over recent years, may be too low, and may not fully reflect the potential for losses in unlikely, but plausible, tail scenarios. The PRA's proposed floors for all exposures other than UK retail residential mortgage exposures would be aligned with the Basel 3.1 standards.

4.199 In PS16/21 – '**Internal Rating Based UK mortgage risk weights: Managing deficiencies in model risk capture**', the PRA noted that calculating IRB mortgage risk weights is inherently uncertain and set out a number of observations that have cumulatively influenced the PRA's concern, and which the PRA considers to still be relevant. These observations included:

- risk weights for low loan to value (LTV) mortgages can be difficult to calibrate due to limited historical experience of either extreme house price falls or the varying effects different types of economic downturn might have;
- average UK IRB mortgage risk weights are below, and in some cases significantly below, international peers;
- a number of other international jurisdictions have acted to address low mortgage risk weights generated from some IRB models;
- there is large variation in IRB risk weights between UK firms, including material variation between loans with similar LTVs;
- the significant difference between residential mortgage risk weights under the IRB approach and risk weights under the SA; and that
- IRB mortgage risk weights have been falling for a number of years. Although it was unclear whether the trend would continue in the short-term given the global pandemic, there remained the risk that the medium- and longer-term trend of falling mortgage risk weights would continue, increasing the likelihood that some IRB mortgage lenders were undercapitalised.

4.200 In response to these concerns, PS16/21 introduced an expectation that firms apply a 10% UK retail residential mortgage portfolio-level risk weight floor, which has applied since 1 January 2022. The PRA proposes now that application of this floor would instead become a requirement.

4.201 The PRA noted in PS16/21 that even after the application of the 10% portfolio-level floor, it continued to have concerns that some individual IRB mortgage risk weights were too low and were a source of prudential risk, and that the divergence between SA and IRB mortgage risk weights raised competition concerns. The PRA therefore noted that as part of its implementation of the Basel 3.1 standards, it would consider whether higher PD and LGD input floors would be introduced.

4.202 The PRA considers that its proposed PD floor of 0.1% for UK retail residential mortgage exposures would achieve an appropriate balance between its concerns regarding the adequate capitalisation of UK residential mortgage exposures, the need to preserve model risk-sensitivity and rank-ordering, and to maintain incentives for firms to develop and maintain high quality models. The PRA considers that introducing a PD floor of 0.1% would:

- address model risk and uncertainty in PD models caused by a lack of historic default data for low risk exposures (ie low LTV mortgages); and
- limit the extent to which a fall in default rates translates to falling RWs, as the PRA considers that this is a key driver of the recent observed decrease in UK residential mortgage risk weights.

4.203 The PRA proposes to apply the 0.1% PD floor to UK retail residential mortgage exposures only. Non-UK retail residential mortgage exposures would be subject to the 0.05% PD floor, in line with the Basel 3.1 standards, as the PRA does not have evidence that a higher PD floor would be justified for non-UK retail residential mortgage exposures.

LGD input floors

4.204 The PRA proposes to implement LGD input floors in line with the Basel 3.1 standards. These floors would be flat (ie non-variable) LGD floors for unsecured and retail residential mortgage exposures, and variable floors for other fully or partially secured exposures.

4.205 The proposed flat LGD floors are set out in the table below:

Table 2: Proposed unsecured and retail residential mortgage LGD floors

Exposure category	LGD Floor
Qualifying revolving retail exposures	50%
Unsecured other retail exposures	30%
Unsecured corporate exposures	25%
Retail residential mortgage exposures	5%

4.206 The variable LGD floors for other fully or partially secured exposures would be calculated at exposure level as a weighted average of the relevant unsecured floor (taken from Table 2 above) and prescribed secured floors (set out in Table 3 below). The weights would be determined by the value of the exposure covered by each type of collateral after application of haircuts specified in the 'foundation collateral method' (collateral not eligible under this method would not be recognised).[21]

4.207 The proposed secured floors that would be used to calculate these variable floors are set out in Table 3 below:

Table 3: Proposed secured LGD floors

Security type	Secured floor
Financial collateral	0%
Receivables	10%
Residential or commercial immovable property	10%
Other physical collateral	15%

4.208 The proposed flat 5% LGD floor for retail residential mortgage exposures would be consistent with the floor that the PRA currently expects firms to apply to these exposures. The PRA proposes that this floor would become a requirement in rules as part of these proposals and that the floor would continue to apply regardless of whether the mortgage exposure is UK or non-UK. This approach would be aligned with the Basel 3.1 standards.

4.209 The PRA proposes to remove the existing 10% exposure-weighted average portfolio LGD floor for residential mortgages in the retail exposure class and the existing 15% exposure-weighted average portfolio LGD floor for commercial mortgages in the retail exposure class. The PRA considers these floors are not required given the proposed retention of a 10% portfolio risk weight floor for retail residential mortgages, the relative low materiality of retail commercial mortgages, and the proposed input floors. Removing these floors would be consistent with the Basel 3.1 standards.

Conversion factor and exposure at default input floors

4.210 The PRA currently would expect that EAD is floored at current drawings and, consequently, that CF estimates are not less than zero. The Basel 3.1 standards introduce a new EAD input floor calculated as the sum of the on-balance sheet amount and the off-balance sheet exposure multiplied by 50% of the applicable SA CF.

4.211 The PRA considers that it is necessary to specify the floor separately for firms that provide own estimates of CFs and firms that provide own estimates of EAD. The PRA therefore proposes the following implementation:

- where a firm provides own estimates of CFs, the PRA proposes that these CF estimates would be floored at 50% of the SA CF; and
- where a firm provides own estimates of EAD, the PRA proposes that these EAD estimates would be floored at the current balance plus 50% of the SA CF multiplied by the off-balance sheet exposure.

4.212 Further details about the cases when firms would provide own estimates of CF or own estimates of EAD are set out in the section 'EAD estimation' below.

> **Question 27: Do you have any comments on the PRA's proposed PD, LGD, and CF or EAD input floors?**

PRA objectives analysis

4.213 The PRA considers that the proposed input floors would advance the PRA's primary objective of safety and soundness because the floors should improve comparability, reduce unwarranted variability, and reduce the cyclicality of modelled risk weights. The PRA considers that the proposed floors would help ensure a minimum level of prudence, in particular for low default portfolios where data are limited.

4.214 The proposals would support the PRA's secondary competition objective as the PRA considers that the input floors would narrow the gap between some IRB and SA risk weights, which would help firms using the SA compete with firms using the IRB approach. This is particularly the case for the proposed PD floor for UK retail residential mortgage exposures.

'Have regards' analysis

4.215 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Relevant international standards (FSMA CRR rules):

- The PRA's proposed PD floor for UK retail residential mortgages would be higher than the minimum floor specified in the Basel 3.1 standards, which the PRA considers to be appropriate in order to address PRA concerns related to the current adequacy of some IRB UK retail residential mortgage risk weights. The PRA's proposed implementation of input floors for all exposures other than UK retail residential mortgage exposures would be aligned with those specified in the Basel 3.1 standards.

2. Relative standing of the UK as a place to operate (FSMA CRR rules) and competitiveness (HMT recommendation letters):

- The PRA expects other jurisdictions to implement similar input floors and to remove exposure-weighted average portfolio LGD floors for retail mortgages, as this would be aligned with the changes introduced in the Basel 3.1 standards. The PRA also notes that it expects firms to use a 90 days past due definition of default for all exposure classes, which results in the existing exposure-weighted average LGD floor for retail mortgages binding on some firms. The proposed removal of this floor may enable firms to apply lower LGDs that better reflect the risk of their exposures and improve the risk-sensitivity of modelled risk weights. The PRA considers that this would support the UK's relative standing.
- The PRA's proposal to increase the PD input floor for UK retail residential mortgages to 0.1% is more conservative than the calibration in the Basel 3.1 standards. However, the PRA would not expect that this would have a material impact on the relative standing of the UK as retail residential mortgage lending is a predominantly domestic market with limited cross-border activity. In addition, several jurisdictions already set materially higher risk weight floors for mortgage exposures than implied by the relatively modest PD floor proposed by the PRA.

3. Proportionality (FSMA regulatory principles and Legislative and Regulatory Reform Act 2006):

- The PRA considers that the proposed input floors would be appropriately prudent, and recognises that there are drawbacks from setting overly conservative floors, such as loss of risk-sensitivity in modelled parameters. The PRA considers the proposed removal of the 10% exposure-weighted average portfolio LGD floor for residential mortgages in the retail exposure class and the 15% exposure-weighted average portfolio LGD floor for commercial mortgages in the retail exposure class would avoid excessive complexity in the input floors framework.

4. Finance for the real economy (FSMA CRR rules):

- The PRA considers that the proposals would support firms' financing of the real economy by ensuring risks are appropriately capitalised. The PRA considers that the proposed floors would reduce cyclicality in risk weights, which should support firms' lending to the real economy throughout the economic cycle.

Probability of default (PD) estimation

4.216 This section sets out the PRA's proposals for PD estimation under the IRB approach to credit risk. For detail on the PRA's proposals relating to PD input floors, please refer to the 'Input floors' section above.

Use of continuous rating scales

4.217 Under the CRR, firms are permitted to apply either discrete or continuous rating scales for PD estimation:

- for discrete rating scales exposures are grouped into rating grades based on risk characteristics, with a PD estimated for each grade; and
- for continuous rating scales exposures are not grouped together – instead, each exposure is assigned an individual PD estimate based on risk characteristics.

4.218 The PRA has observed that, for PD estimation, continuous rating scales are used relatively infrequently by firms, and that most firms adopt discrete rating scales in their hybrid mortgage model applications.

4.219 The PRA considers that the use of continuous rating scales for PD estimation could typically result in lower RWAs than the use of discrete rating scales. This is because total RWAs tend to reduce as the number of grades increases, due to the shape of the IRB risk weight function in respect of PD. While increasing the number of grades could potentially result in more accurate RWAs, the PRA considers that this is only justified where the extra grades result in a genuine increase in risk capture. The PRA also considers that adding additional grades does not increase risk-sensitivity beyond a certain point, and therefore a risk of continuing to allow continuous rating scales for PD estimation is that these reduce RWAs without increasing the overall risk capture of the model.

4.220 The PRA therefore proposes to prohibit the use of continuous rating scales in PD models and to require firms to use discrete rating scales instead. The PRA considers that this proposal is aligned with the Basel 3.1 standards.

4.221 The PRA recognises that a consequence of this proposal is that variable scalar approaches, where firms transform point-in-time (PiT) or hybrid rating systems to through-the-cycle (TtC) outcomes, would no longer be permitted. This is because the mechanics of variable scalar approaches effectively result in firms using a continuous rating scale. The PRA considers this would be an appropriate outcome given the concerns that the PRA has previously identified regarding the risk capture of variable scalar approaches, and considers that the number of models affected following the introduction of hybrid modelling for mortgage portfolios would be low. The PRA therefore proposes to withdraw its existing expectations relating to the use of variable scalar approaches.

4.222 The PRA does not consider that similar prudential concerns arise from the use of continuous rating scales for LGD and EAD models because the IRB risk weight formula is linear in LGD and EAD. The PRA therefore does not propose to restrict the use of continuous rating scales for LGD and EAD.

Obligor grade adjustments

4.223 For exposures to corporates and institutions, for which the exposures to the obligor are subject to a guarantee, the Basel 3.1 standards and the CRR generally require firms to assign all exposures to a particular obligor to the same obligor grade, irrespective of differences in the nature of each transaction. However, the CRR also sets out a number of exceptions to this requirement, including that the treatment of the guarantees could be reflected in an adjusted obligor grade assignment.

4.224 The PRA proposes to clarify that adjustments to obligor grade assignments could be made outside the credit risk mitigation (CRM) framework and therefore the CRM eligibility criteria would not apply.

4.225 In addition, the PRA considers that the purpose of these adjustments to obligor grades is to reflect reductions in default risk arising from the existence of guarantees rather than to reflect potential recoveries in the event that default occurs. In practice, the PRA recognises that firms could interpret existing requirements to permit firms to recognise a wider range of support arrangements including, for example, letters of comfort as well as verbal and implicit indications of support.

4.226 The PRA considers that it would be desirable for firms to reflect support arrangements in PD models where they are able to demonstrate a reduction in default risk, as the PRA considers that linking RWAs to risks advances the PRA's primary objective. As such, the PRA proposes to continue to permit firms to reflect certain support arrangements in IRB obligor rating grade assignments.

4.227 However, the PRA considers that undocumented support arrangements are often unclear and not robust. In addition, the PRA considers that it is difficult for firms to demonstrate a reduction in default risk from these arrangements, and it is difficult for supervisors to challenge whether these arrangements are appropriately reflected in IRB models. The PRA therefore proposes that adjustments to obligor grades would only be permitted where the support arrangements are in writing.

4.228 In order to implement this proposal the PRA proposes to:

- exclude undocumented support arrangements from the requirements to incorporate 'all available information' in IRB rating systems and require firms to disregard this information for the purpose of assignment of exposures to obligor grades;
- require firms to disregard undocumented support arrangements when assessing model overrides; and
- clarify that all documented support arrangements and not just guarantees could potentially be recognised.

4.229 Firms reflecting unfunded credit protection (UFCP) in PD or LGD are required to floor risk weights at the risk weight that would apply to a comparable direct exposure to the protection provider. The PRA proposes to extend the scope of this floor to firms using obligor grade adjustments in order to provide a further safeguard against the effect of protection arrangements being over-reflected in RWAs.

4.230 The PRA considers that the Basel 3.1 standards are open to interpretation in respect of the interaction of obligor grade adjustment with CRM techniques, for example PD substitution (which the PRA proposes to retain) and PD adjustment (which the PRA proposes to withdraw). Further details of the PRA's proposals regarding this interaction are set out in Chapter 5.

Other proposals

4.231 The PRA also proposes to make the following minor amendments to PD estimation:

- clarify that firms would be required to consider 'seasoning' as a risk driver for retail exposures, in line with the Basel 3.1 standards. See Appendix 13;

- move an existing expectation that PD estimates should be based on a representative mix of good and bad economic periods to PRA rules and make a number of clarifications to related expectations. See Credit Risk: Internal Ratings Based Approach (CRR) Part and Appendix 13;
- withdraw the option for firms to place greater weight on more recent observations for retail exposures, in line with the Basel 3.1 standards;
- clarify that a PD needs to be estimated for each rating grade and that this would need to be based on a count-weighted average of one-year defaults in line with the Basel 3.1 standards (the PRA considers that the proposal does not represent a substantive change to existing requirements). See Appendix 13;
- introduce an expectation that firms using the parameter substitution method (as described in Chapter 5) should collect information on the performance of the obligor and the exposure and use this information in PD estimation where appropriate. See Appendix 13;
- withdraw existing expectations relating to the consistency of time horizons in different stages of the modelling process (the PRA considers it can be desirable for firms to apply different time horizons for the purpose of assigning exposures to rating grades and for the purpose of model calibration in certain circumstances);
- withdraw existing expectations relating to making conservative adjustments due to old financial statements and external ratings (these relate to requirements set out in an EBA Final Draft RTS[22] that was not implemented in the UK);
- withdraw existing expectations related to the treatment of missing ratings because the PRA considers that all exposures within the scope of a rating system should be rated, and should be rated in a conservative manner where there is missing information; and
- clarify that the effect of any UFCP would be required to be excluded from PD models where the SA 'risk weight substitution method' is applied to exposures under the IRB approach. See Appendix 13.

Question 28: Do you have any comments on the PRA's proposals on PD estimation?

PRA objectives analysis

4.232 The PRA considers that the proposals set out in this section would advance the PRA's primary objective. The proposals aim to reduce the prudential risk that firms' IRB models do not adequately reflect risks and therefore result in underestimation of RWAs. In addition, the proposal to prohibit the reflection of undocumented support arrangements in assignments to obligor rating grades would reduce the risk that support arrangements that do not result in the expected risk-mitigating effect are recognised. This would therefore promote the safety and soundness of firms.

4.233 The PRA considers that the proposals set out in this section facilitate effective competition. All the proposals in this section would apply equally to firms using the FIRB and AIRB approaches, which the PRA considers would facilitate effective competition between them.

'Have regards' analysis

4.234 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Growth (HMT recommendation letters), finance for the real economy (FSMA CRR rules), and sustainable growth (FSMA regulatory principles):

- Continuing to recognise documented support arrangements in PD models would support sustainable financing and growth by better linking RWAs to risks. The PRA considers that in order for lending to be sustainable and growth to be supported, RWAs should appropriately reflect risk.

2. Competitiveness (HMT recommendation letters) and relative standing of the UK as a place to operate (FSMA CRR rules):

- The PRA would expect the net effect of the proposals in this section to be in line with other jurisdictions, and therefore considers that the proposals set out in this section would not have a significant impact on the competitiveness or relative standing of the UK.

3. Relevant international standards (FSMA CRR rules):

- The PRA considers that the Basel 3.1 standards are open to interpretation about how adjustments to borrower grades should be treated. However, the PRA considers that its proposed approach is broadly aligned with international standards. The PRA considers that the other proposals set out in this section are aligned with the Basel 3.1 standards.

4. Proportionality (FSMA regulatory principles and Legislative and Regulatory Reform Act 2006):

- The PRA recognises that its proposal to prohibit continuous rating scales for PD estimation may mean that some existing IRB models could have to be rebuilt. However, as outlined above, the PRA considers that the number of models affected is likely to be low.

In addition, the PRA considers that the proposed IRB implementation timelines set out in this chapter would reduce the burden on firms by giving them an appropriate amount of time to make any required model changes.

5. Efficient and economic use of the PRA's resources (FSMA regulatory principles):

- The PRA considers that certain proposals in this section, for example the removal of recognition of certain types of support arrangements, would reduce the amount of time and resources it spends reviewing models that are unlikely to be sufficiently robust. This would enable the PRA to focus its resources more efficiently.

Loss given default estimation

4.235 This section sets out the PRA's proposals relating to LGD estimation, including the impact of CRM on LGD models.

FIRB LGD values for unsecured corporate senior claims

4.236 Firms using the FIRB approach currently apply a 45% LGD for all unsecured exposures to corporates that are senior claims. The Basel 3.1 standards reduce the FIRB LGD value for these exposures from 45% to 40%, with the exception of exposures to financial corporates where the FIRB LGD remains at 45%. The BCBS calibrated the new FIRB LGD value using international empirical data and the PRA does not have any evidence to suggest this is not an appropriate calibration.

4.237 The PRA therefore proposes to align with the Basel 3.1 standards and reduce the FIRB LGD value for exposures to non-financial corporates that are senior claims to 40%. The PRA does not propose to change the existing 45% FIRB LGD value for exposures to financial corporates that are senior claims.

LGD modelling collateral method for firms using the AIRB approach

4.238 Firms using the AIRB approach typically reflect the risk mitigating impact of collateral in their LGD models. As set out in Chapter 5, the PRA proposes a number of restrictions on where this approach (which the PRA proposes to call the 'LGD modelling collateral method') may be applied.

Approach to ineligible and disregarded collateral

4.239 When recognising collateral in LGD estimates while using the AIRB approach, firms are currently required to establish internal requirements for collateral management, legal certainty, and risk management that are generally consistent with those set out in the CRM chapter of the CRR. The PRA proposes to retain this approach for firms using the LGD modelling collateral method subject to clarifying that the relevant CRM standards are those that apply to firms using the FIRB approach, in line with the Basel 3.1 standards. The PRA also proposes to clarify that collateral that does not meet these requirements should be classed as ‘ineligible’ for the purpose of applying the LGD modelling collateral method.

4.240 In addition, there is currently some ambiguity in the CRR regarding whether firms using the AIRB approach have the option to disregard eligible collateral. This is because firms are required to use ‘all relevant information’ when developing their models.

4.241 The PRA considers that it is desirable to allow firms using the LGD modelling collateral method to disregard eligible collateral in order to be more consistent with the approach taken for firms using the SA and the FIRB approach in order to help limit complexities and operational costs for firms. The PRA considers that it is particularly desirable for firms to be able to disregard eligible collateral should they wish to in cases where collateral is difficult to model. The PRA therefore proposes to allow firms to disregard eligible collateral when using the LGD modelling collateral method. In such cases, a firm would treat the part of the exposure covered by disregarded collateral as being unsecured.

4.242 Firms are currently subject to an expectation that recoveries from ineligible collateral should be included in estimates of unsecured LGD, but with appropriate adjustments to avoid bias in LGD estimates. The PRA proposes to withdraw that expectation and to instead require firms applying the LGD modelling collateral method to exclude recoveries from ineligible and disregarded eligible collateral when calculating unsecured LGD. The PRA also proposes to clarify in PRA rules that firms would not include ineligible and disregarded eligible collateral as a risk driver in LGD models.

4.243 The PRA considers that if cash flows from ineligible and disregarded eligible collateral were included in LGD estimates, it would effectively negate the classification of the collateral as ineligible or disregarded and bias estimates. The PRA considers this could give rise to prudential risks.

4.244 Related to this, firms are also currently subject to an expectation that, where they do not regularly sell credit obligations as part of their recovery processes, and the allocation of the part of the price related to collaterals is too burdensome to make or too unreliable, they can decide not to take these observations into account in the model development process. In contrast, the Basel 3.1 standards permit firms to simply derecognise the collateral for these cases. Therefore, the PRA proposes to remove this expectation and align with the Basel 3.1 standards.

Proposed introduction of an alternative methodology

4.245 The Basel 3.1 standards introduce an alternative methodology for firms using the AIRB approach, to address the challenge of modelling robust LGD estimates where there are limited data. Under the alternative methodology, firms calculate LGD by combining modelled LGD estimates for the unsecured part of an exposure with FIRB LGD parameters for the secured part of an exposure.

4.246 The PRA recognises the modelling challenges identified by the BCBS and therefore proposes to introduce an alternative methodology as part of the LGD modelling collateral method, which the PRA proposes would be applied in cases where firms lack sufficient data to model collateral recoveries. The PRA proposes that LGD under the alternative methodology would be calculated using the following formula where a single type of collateral is recognised:

$$LGD^{*} = LGD_{U} \cdot \frac{E_{U}}{E \cdot (1 + H_{E})} + LGD_{S} \cdot \frac{E_{S}}{E \cdot (1 + H_{E})}$$

where:

- LGD^* is the LGD applicable to a collateralised transaction;
- LGD_U is the estimated LGD of the exposure disregarding collateral (ie treating the exposure as unsecured);
- LGD_S is the foundation collateral method secured LGD applicable to the collateral type;
- E is the current value of the exposure after the effect of on-balance sheet netting;
- E_S is the current value of the collateral after the application of the applicable volatility adjustment (H_C);[23]
- E_U is the value of the unsecured exposure calculated as follows:

$$E_{U} = E \cdot (1 + H_{E}) - E_{S}$$

- H_C is the volatility adjustment applied to the collateral (as defined according to the financial collateral comprehensive method for financial collateral and according to the foundation collateral method for non-financial collateral); and
- H_E is the volatility adjustment applicable to the exposure.

4.247 The proposed formula is in line with that proposed for firms applying the foundation collateral method, as set out in Chapter 5 (an analogous formula would be applied where multiple collateral types are recognised). In particular, LGD_S, E, E_U, E_S, H_C and H_E would be calculated in accordance with the foundation collateral method and only LGD_U would be estimated by firms. As a result, only collateral eligible under the foundation collateral method would be recognised under the alternative methodology.

4.248 The PRA proposes that firms using the alternative methodology would be required to estimate LGDU using an approved IRB model. The PRA also proposes that firms would not be permitted to take account of collateral recoveries in the model used to estimate unsecured LGD to avoid double counting the effect of the collateral.

4.249 The PRA proposes to require the use of the alternative methodology if a firm is using the LGD modelling collateral method to recognise the effect of collateral and does not have sufficient data to model the effects of the collateral. The PRA proposes to set an expectation that the data would be considered insufficient where firms have fewer than 20 relevant data points for any non-financial collateral that the firm wishes to recognise in their LGD models. This corresponds to a condition already in place in the PRA's wholesale LGD framework (which the PRA proposes to remove as set out later in this section). The PRA does not propose to set an equivalent expectation for financial collateral, in line with its existing approach.

Other proposed minor amendment

4.250 The PRA proposes to introduce an expectation that firms estimating LGDs should, when calculating realised LGDs, reflect any recognised netting agreements in the EAD parts of the LGD calculation but should not treat any cash flows arising from netting as post-default recoveries in the economic loss part. This expectation would be consistent with the PRA's proposals that netting agreements would only be recognised through exposure values as set out in the Chapter 5, and would complement existing guidance regarding the calculation of realised LGDs. See Appendix 13.

LGD adjustment method for unfunded credit protection (UFCP)

4.251 As noted in Chapter 5, the PRA proposes to describe recognition of UFCP in LGD estimates as the 'LGD adjustment method'. Firms using UFCP would be able to use this method subject to the restrictions set out in that chapter.

4.252 The PRA proposes to clarify the eligibility requirements for recognising UFCP that would apply as part of the LGD adjustment method in order to bring these more in line with the eligibility requirements that would apply when firms use alternative CRM methods to recognise UFCP.

Combination with adjustments to obligor grades

4.253 As noted in Chapter 5, while the PRA proposes to withdraw the option of adjusting PD to reflect UFCP, it proposes to continue to permit firms to recognise support arrangements through the adjustment of obligor grades in some circumstances. The PRA notes that both the CRR and the Basel 3.1 standards are open to interpretation about whether firms can combine the LGD adjustment method with adjustments to obligor grades.

4.254 The PRA considers that for firms to simultaneously apply the LGD adjustment method and reflect the impact of a guarantee by adjusting obligor grades without double counting is challenging. The PRA therefore proposes to clarify that firms applying the LGD adjustment method would not be permitted to also reflect the effect of the guarantee by adjusting obligor grades.

Modelling standards

4.255 The PRA proposes to introduce enhanced expectations regarding modelling standards for firms applying the LGD adjustment method to help ensure that LGD estimates are sufficiently robust. The proposed expectations (also see Appendix 13) would include:

- that firms should have clear policies for assessing the effects of UFCP that are consistent with internal risk management practices; and
- that firms should reflect currency mismatches, correlation between the protection provider's and the obligor's ability to pay, and the defaulted status of the protection provider (where relevant).

Approach to ineligible and disregarded UFCP

4.256 In line with the proposals relating to collateral, the PRA proposes to clarify that recognition of UFCP within the LGD adjustment method is optional and therefore firms could choose to disregard UFCP. The PRA also proposes to prohibit the recognition of UFCP in LGD models if firms are not using the LGD adjustment method as well as where the UFCP is ineligible or has been disregarded.

Calculation of LGD when applying the parameter substitution method

4.257 As set out in Chapter 5, the PRA proposes that firms using the AIRB approach that wish to recognise the effects of UFCP would be required to apply the risk weight substitution method under certain circumstances, and would be required or permitted to use the parameter substitution method in specific other circumstances. In order to apply either of these methods, it would be necessary for firms using the AIRB approach to estimate LGD values for the exposures as if there were no UFCP.

4.258 The PRA proposes to clarify the framework by setting an expectation that, for the purpose of estimating LGDs as if there was no UFCP (also see Appendix 13):

- cash flows from the protection provider would not be taken into account;
- cash flows for funded credit protection (FCP) associated with the exposure could be taken into account in respect of the part of the exposure covered by the FCP;
- indirect costs would be taken into account in line with the principles and techniques that firms use in their own accounting systems;

- direct costs that are linked to the exercising of the UFCP would not be taken into account, but all other direct costs would be taken into account; and
- direct costs relating to the realisation of FCP would be taken into account in respect of the part of the exposure covered by the FCP.

Use of elements of the SA and the FIRB approach in LGD estimates

4.259 The PRA considers that it may be appropriate for firms applying the AIRB approach to incorporate elements of the SA and the FIRB approach within their LGD models in specific circumstances (for example by incorporating the supervisory haircuts used in the 'financial collateral comprehensive method' (FCCM)). The PRA proposes to introduce an expectation that firms should provide appropriate justification for their approach.

Removal of the PRA's wholesale LGD framework

4.260 The PRA's wholesale LGD framework was introduced by the Financial Services Authority (FSA) in 2012 to address modelling deficiencies for low default portfolios. The framework aims to help ensure that LGD estimates do not assume a level of recoveries that is not supported by data.

4.261 The PRA proposes in this CP to introduce three new constraints that would reduce the need for the PRA's wholesale LGD framework:

- prohibiting LGD modelling for exposures to institutions, financial corporates, and large corporates (see section 'Restrictions on LGD modelling');
- for corporate exposures where LGD modelling would still be permitted, introducing LGD input floors (see section 'LGD input floors'); and
- introducing the LGD alternative methodology under the LGD modelling collateral method where there is limited data to model collateral recoveries (as set out in this section).

4.262 The PRA has considered whether to retain the wholesale LGD framework in light of the above proposed modelling constraints. The PRA notes that the wholesale LGD framework was predominantly targeted at exposures to institutions, financial corporates, and large corporates, as these are typically the most significant low default portfolios. The PRA considers that the proposed prohibition of LGD modelling for these exposure classes would materially address the risks that the wholesale LGD framework targets.

4.263 The PRA also considers that removal of the wholesale LGD framework would strike an appropriate balance between ensuring that LGDs are not too low where firms have insufficient data and ensuring that the overall approach is not excessively conservative. The proposed introduction of the above constraints would increase conservatism in the LGD framework prior to application of the PRA's wholesale LGD framework, which would reduce the need for application of the wholesale LGD framework. The PRA also considers that to remove the wholesale LGD framework would prevent an excessively complex regime.

4.264 As a result of the above considerations, the PRA proposes to withdraw its wholesale LGD framework.

Other LGD proposals

4.265 For the calculation of dilution risk for purchased receivables, firms that do not decompose their EL estimates into PD and LGD currently set their PD estimates equal to their EL estimate and apply a 75% LGD. The PRA considers that the existing approach is inconsistent and results in understated RWAs. EL is defined as the product of PD and LGD, so to set PD equal to the EL estimate implies that LGD should be set at 100%. The PRA therefore proposes to set LGD equal to 100% if the decomposed approach is not used. This is in line with the Basel 3.1 standards. See Credit Risk: Internal Ratings Based Approach (CRR) Part.

4.266 The PRA proposes to permit firms to reflect post-default additional drawings in LGD instead of EAD for non-retail and retail exposures, and to require that firms reflect pre-default additional drawings in EAD rather than LGD. Further details about these proposals are set out in the EAD estimation section. See Credit Risk: Internal Ratings Based Approach (CRR) Part and Appendix 13.

4.267 The PRA proposes to permit firms to assume zero recoveries for incomplete workouts as an alternative to applying the approach to modelling of incomplete workouts that is currently set out in its expectations. The PRA considers that the proposal would improve the accessibility of the IRB framework for firms that are unable to model incomplete workouts robustly. The PRA considers removing this unnecessary barrier to those firms would advance the PRA's secondary objective of facilitating effective competition. See Appendix 13.

4.268 The PRA also proposes to make the following minor changes to LGD estimation:

- withdrawing an expectation that long-run average (LRA) LGD should reflect a representative mix of good and bad economic periods. Instead, the LRA LGD would reflect all observed defaults within the data sources, in line with the Basel 3.1 standards. See Credit Risk: Internal Ratings Based Approach (CRR) Part and Appendix 13;
- clarifying that firms need only calculate LRA LGD at portfolio level if they are calibrating LGD estimates at portfolio level. See Appendix 13;
- amending the hierarchy of approaches for calibrating downturn LGD so that firms would be able to base LGD estimates on estimated impact without having to first show that they

do not have sufficient and relevant loss data to base LGD estimates on observed impact. See Appendix 13;

- withdrawing the option for firms to calibrate downturn LGD as LRA LGD plus 15%. The EBA Guidelines on PD estimation, LGD estimation and treatment of defaulted assets currently permit this, but the PRA has an existing expectation that this approach should not be used. See Appendix 13;
- clarifying that firms which base estimates of 'best estimate of expected loss' on LRA estimates, should adjust these to reflect current economic conditions where necessary, and that in certain circumstances, no adjustment is necessary. See Appendix 13; and
- revoking PRA Standards Instrument: Technical Standards (Economic Downturn) 2021 and transferring its contents to the PRA Rulebook in order to increase the coherence and accessibility of the framework. See Credit Risk: Internal Ratings Based Approach (CRR) Part.

Question 29: Do you have any comments on the PRA's proposals to LGD estimation?

PRA objectives analysis

4.269 The PRA considers that the proposed approach to LGD estimation set out in this section would advance the PRA's primary objective of safety and soundness. The proposed reduction in the FIRB approach LGD value for unsecured corporate exposures for senior claims (excluding financial institutions) was calibrated by the BCBS based on international empirical data. Therefore, the PRA considers that the proposal would support the safety and soundness of firms. The other proposals are designed to improve the robustness of LGD estimates. For example, the PRA considers that the proposed introduction of the LGD alternative methodology under the LGD modelling collateral method should result in more robust LGD estimates, as firms would not be permitted to model collateral recoveries when they have limited data to do so effectively.

4.270 The proposed removal of the PRA's LGD wholesale framework reflects the proposed introduction of three new constraints on LGD modelling. The PRA considers that these proposed measures, on balance, would result in an appropriate degree of conservatism.

4.271 The PRA considers the proposed LGD value of 100% to be appropriate for dilution risk for exposures to purchased receivables where the decomposed approach is not used, as it considers the existing 75% LGD value to be inconsistent and insufficiently prudent as outlined above.

4.272 The PRA considers that the different changes proposed in this section would potentially have different impacts on competition but it does not expect that the proposals to adversely impact the facilitation of effective competition overall. The PRA considers that the proposal to permit firms to assume zero recoveries for incomplete workouts as an alternative to modelling incomplete workouts should make the IRB framework more accessible to firms that are unable to model incomplete workouts robustly, which could help facilitate firms using the SA to obtain IRB permission. The PRA considers that the proposal to allow firms using the LGD modelling collateral method to disregard eligible collateral would make the treatment under the AIRB approach more consistent with the treatment for firms using the SA and the FIRB approach, which should improve competition between firms using different approaches.

'Have regards' analysis

4.273 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Proportionality (FSMA regulatory principles and Legislative and Regulatory Reform Act 2006):

- The PRA considers that the proposed removal of the PRA's wholesale LGD framework would be a proportionate measure to reduce duplication and complexity in the regulatory framework, given the new constraints on LGD modelling that the PRA proposes to introduce. The PRA considers its proposals for the treatment of ineligible or disregarded eligible collateral under the LGD modelling collateral method could result in additional operational costs and complexities for firms and potentially higher RWAs. The PRA considers; however, that any potential costs or RWA increases are justified as it considers firms should not reflect cash flows from ineligible or disregarded collateral in their LGD models. This is because including such cash flows could bias the models and effectively result in the collateral being recognised, leading to imprudent RWAs.

2. Competitiveness (HMT recommendation letters) and relative standing of the UK as a place to operate (FSMA CRR rules):

- The PRA expects other jurisdictions to also implement the reduction of the FIRB approach LGD value for exposures to unsecured corporates for senior claims (excluding financial institutions). The PRA considers that the proposed introduction of an alternative methodology under the LGD modelling collateral method and the proposed removal of the PRA's wholesale LGD framework would improve the competitiveness and relative standing of the UK, as the PRA would expect that the result of these proposals is that the PRA's requirements for low default portfolios are more closely aligned with other jurisdictions. The proposed introduction of the 100% LGD value for dilution risk for purchased receivable exposures is aligned with the approach that the PRA would expect to be taken by other jurisdictions.

3. Relevant international standards (FSMA CRR rules):

- There PRA considers that the Basel 3.1 standards are open to interpretation regarding whether firms using the AIRB approach could disregard eligible collateral, and whether firms could reflect recoveries from ineligible collateral in LGD estimates. However, the PRA considers that its proposals are broadly aligned with the Basel 3.1 standards. The PRA considers the other proposals set out in this section are aligned with the Basel 3.1 standards.

4. Efficient and economic use of PRA resources (FSMA regulatory principles):

- The PRA considers that while additional supervisory resources could be required in the short- to medium-term to monitor the implementation of the proposed LGD alternative methodology under the LGD modelling collateral method and the proposed removal of the PRA's wholesale LGD framework, the incremental increase in resource required would be low.

Exposure at default estimation

4.274 This section sets out the PRA's proposals on EAD estimation under the IRB approach.

4.275 CFs are used to calculate an exposure value (referred to as a credit equivalent amount) for off-balance sheet items. The PRA proposes to align the CFs in the FIRB approach with its proposed revised CFs that would apply under the SA (see Chapter 3). This proposal includes analogous treatments for undrawn purchase commitments for revolving purchased receivables.

4.276 The PRA proposes to split CRR Article 166 into four separate articles (166A to 166D) in order to more clearly reflect the methods it proposes for calculating exposure values under the FIRB approach and the AIRB approach.

4.277 The PRA also proposes to introduce an 'unrecognised exposure adjustment' to RWAs in order to reflect risks falling outside the scope of IRB approaches for EAD. This proposal is discussed in section 'Calculation of risk-weighted assets (RWA) and expected loss (EL)' above.

Scope of EAD modelling under the AIRB approach

4.278 Firms using the AIRB approach currently provide own estimates of CFs or EAD for most off-balance sheet exposures. The Basel 3.1 standards restrict the scope of EAD modelling under the AIRB approach to revolving commitments only, although the PRA notes the Basel 3.1 standards could be subject to differing interpretations about which exposures are intended to be included in the definition of revolving commitments. The PRA considers a reasonable interpretation of the Basel 3.1 standards is that modelling would be restricted under the AIRB approach to revolving loan facilities, given that the BCBS introduced this restriction because of its concerns that a lack of data and firm modelling capability resulted in unwarranted RWA variability for these types of exposures.[24]

4.279 The PRA shares the concerns identified by the BCBS and therefore proposes to align with the Basel 3.1 standards by restricting the scope of EAD modelling to revolving commitments in the form of revolving loan facilities only, meaning that:

- for issued off-balance sheet items, non-revolving commitments, and all commitments to issue off-balance sheet items or purchase assets, firms would apply the CFs set out in Chapter 3 in order to calculate exposure value; and
- for on-balance sheet exposures, firms would calculate exposure value in line with the FIRB approach (subject to one exception discussed below).[25]

4.280 The PRA considers that the proposed restrictions on modelling off-balance sheet exposures are appropriate as it considers firms' existing modelling approaches for these exposures is inconsistent, resulting in unwarranted variation in EAD estimates between firms. The PRA considers that it is challenging for firms to produce robust EAD models for issued off-balance sheet items given the lack of relevant data available. In contrast, the PRA considers that the benefits of continuing to allow modelling of revolving commitments in the form of revolving loan facilities outweigh the disadvantages as the SA is less able to capture the dynamics of flexible drawdowns.

4.281 For on-balance sheet exposures, the PRA considers that prohibiting modelling would result in greater consistency across the framework. While firms typically have greater capability to model on-balance sheet exposures than non-revolving commitments and issued off-balance sheet items, the PRA considers that permitting modelling for on-balance sheet exposures while prohibiting modelling for non-revolving commitments would result in unwarranted complexity in the framework. This is because firms would potentially be required to start modelling EAD only once a commitment is fully drawn down, or alternatively apportion accrued interest on a facility between the on-balance sheet part (which would be modelled) and the off-balance sheet part (which would not be modelled).

4.282 The PRA does; however, consider that it is necessary to make an exception for on-balance sheet exposures that are connected to a revolving facility (eg a credit card exposure that is partly drawn down or is at, or over, its limit). The PRA considers that it is impractical for firms to model only the off-balance sheet part of revolving exposures and it therefore proposes that:

- if an on-balance sheet exposure and a revolving commitment relate to the same facility, firms' models should incorporate increases in EAD arising from the on-balance sheet exposure as well as the revolving commitment; and
- if a revolving exposure is at or over its limit, firms should continue to model EAD.

4.283 The PRA currently has an expectation that enables firms to model EAD directly in place of the CF estimates that are required by the CRR. The PRA proposes to continue the substance of its existing approach but to formalise the approach into PRA rules. For revolving exposures that are at or over limit, firms would be required to model EAD directly as the PRA considers that CFs are not a meaningful concept for on-balance sheet exposures. The PRA proposes to make a number of related changes to its rules and expectations relating to the modelling of EAD and CFs.

4.284 Overall, the PRA considers that its proposals relating to EAD would advance the safety and soundness of firms and enhance effective competition among firms by ensuring that a consistent and transparent approach is taken to EAD estimation.

Removal of EAD modelling under the slotting approach

4.285 Firms are currently able to model EAD for specialised lending exposures that are risk-weighted using the slotting approach if they have received permission from the PRA. The PRA considers that the Basel 3.1 standards are open to interpretation regarding how EAD should be determined for slotted exposures.

4.286 The PRA considers that it is typically challenging for firms to model EAD robustly for slotted exposures because of a lack of relevant data. The PRA proposes to limit EAD modelling to revolving commitments, as set out above, and the PRA considers that as a result of that proposal, EAD modelling would likely only be available for a limited number of slotted exposures.

4.287 The PRA therefore proposes to prohibit modelling of EAD for exposures subject to the slotting approach as it considers that this would reduce unnecessary complexity in the regulatory framework.

Requirement for a 12-month fixed-horizon approach for EAD modelling

4.288 Firms are currently able to define the modelling horizon for EAD models in one of two ways:

- the 'cohort approach' where facilities are observed on a given date and default could occur at any point in the 12 months following the observation point (resulting in an average time horizon of 6 months); and

- the ‘fixed-horizon approach’ where the observation point is fixed at 12 months prior to the point of default.

4.289 The Basel 3.1 standards introduce a 12-month fixed-horizon approach for all EAD models. The BCBS took this approach in order to reduce unwarranted variation in RWAs and to avoid potential underestimation that could arise from EAD estimates being based on too short a time horizon. Underestimation could occur if estimates are based on a period where the rate of drawdown has decreased due to accounts approaching default (eg as a result of account management measures applied by the firm), and these estimates are then applied to accounts further from default where the rate of drawdown is greater.

4.290 The PRA proposes to align with the Basel 3.1 standards and require firms to use a 12-month fixed-horizon approach for EAD modelling. The PRA considers that there are benefits in standardising the time horizon for EAD modelling domestically and internationally as this would reduce unwarranted risk weight variability.

4.291 The PRA notes that firms could incur operational costs in redeveloping their EAD models in cases where the ‘cohort approach’ is currently used. However, the PRA considers that these costs would be reduced due to the PRA’s proposed timelines for model submission (set out in section ‘Implementation timelines’). The proposed timelines would enable firms, in many cases, to make changes arising from these proposals at the same time as other changes needed to implement the IRB roadmap.

Treatment of additional drawings

4.292 Firms are currently required to estimate post-default additional drawings for non-retail exposures in their EAD estimates. While this is aligned with the Basel 3.1 standards, the PRA would expect some jurisdictions to require post-default additional drawings to be reflected in LGD.

4.293 The PRA considers that post-default additional drawings could legitimately be reflected in either EAD or LGD. The PRA considers that taking a different approach from other jurisdictions could result in unnecessary costs for firms that operate cross-border, and considers that it would not be proportionate to require firms to redevelop existing approaches.

4.294 The PRA therefore proposes that firms would be permitted to recognise post-default additional drawings in either EAD or LGD for non-retail exposures as well as for retail exposures.

4.295 The PRA also proposes to:

- withdraw an existing PRA expectation that additional drawings beyond a 12-month time horizon need not be incorporated in model estimates, in order to align with the Basel 3.1

standards; and

- clarify in its rules that pre-default additional drawings would be required to be reflected in EAD estimates as currently outlined in an existing expectation.

4.296 The PRA considers that its proposed approach to the recognition of additional drawings is prudent and proportionate. The proposal to permit firms to recognise post-default additional drawings in EAD or LGD would provide firms with flexibility and avoid unnecessary costs being placed on firms.

Removal of PRA's wholesale EAD framework

4.297 The PRA currently would expect firms to apply its wholesale EAD framework for low-default portfolios. Under this framework, firms with limited data could either:

- rank-order the off-balance sheet product types (separately for lending and trade finance) according to their drawdown risk. The CF for a product with 20 or more default observations could then be applied to low-default products with a lower drawdown risk; or
- use 50% of the CF for committed credit lines to determine the CFs for uncommitted credit lines; or
- apply the FIRB approach parameters.

4.298 The PRA considers that as a result of the other proposals set out in this CP, its wholesale EAD framework would no longer be necessary. This is because the PRA's existing framework is mainly targeted at exposures to institutions, financial corporates, and large corporates, which the PRA proposes would move to the FIRB approach. In addition, the PRA proposes to implement input floors for EAD estimates, which would help ensure a minimum level of prudence of EAD estimates. The PRA therefore proposes to withdraw its wholesale EAD framework.

Other EAD modelling proposals

4.299 The PRA also proposes the following changes to EAD modelling:

- to withdraw an expectation that estimates of long-run average EAD reflect a representative mix of good and bad economic periods. Instead, the PRA proposes that long-run average EAD estimates would reflect all observed defaults within the data sources, in-line with the Basel 3.1 standards. See Credit Risk: Internal Ratings Based Approach (CRR) Part;
- to introduce an expectation that CF estimates should not be biased by exposures that are close to limit (where firms estimate CFs directly), in-line with the Basel 3.1 standards. See Appendix 13;

- to set an expectation that firms should not cap realised EADs or CFs in reference data to the principal amount outstanding. The PRA also proposes to introduce an expectation that accrued interest, other due payments and limit excesses should be included in EAD reference data. See Appendix 13;
- to clarify that firms modelling EAD should only make adjustments to remove the effect of limit increases from EAD data where this can be done in a robust manner. See Appendix 13;
- to introduce a rule that firms should collect data on limits and balances used to derive CF and EAD estimates and to produce realised CFs and EADs. See Credit Risk: Internal Ratings Based Approach (CRR) Part; and
- to revoke PRA Standards Instrument: Technical Standards (Economic Downturn) 2021 and transfer its contents to the PRA rulebook in order to increase the coherence and accessibility of the framework (as mentioned in the LGD sub-section).

Question 30: Do you have any comments on the PRA's proposals to EAD estimation?

PRA objectives analysis

4.300 The PRA considers that its proposals for EAD modelling advance its primary objective. The PRA considers the proposals minimise complexity and enhance the transparency of the EAD modelling framework for firms. The PRA considers that its proposals to limit the scope of EAD modelling and to standardise the time horizon over which EAD is modelled would help ensure firms take consistent approaches and reduce RWA variability across firms. This would contribute to safety and soundness.

4.301 The PRA has assessed whether the proposals on EAD modelling would facilitate effective competition. The PRA considers that its proposals would reduce RWA variation across firms using the IRB approach, which would facilitate effective competition through a more level playing field between firms. In addition, the PRA considers that its proposals to reduce the complexity and enhance the transparency of its EAD modelling standards would increase the accessibility of the IRB framework, which could be beneficial for firms currently using the SA that are considering applying for IRB permissions.

'Have regards' analysis

4.302 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA),

the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Proportionality (FSMA regulatory principles and Legislative and Regulatory Reform Act 2006):

- The PRA has taken into account the practicalities and difficulties for firms in modelling EAD when arriving at its proposals to prohibit EAD modelling of on-balance sheet exposures, non-revolving commitments, and specialised lending exposures subject to the slotting approach. It considers that its proposals are proportionate.
- The PRA considers its proposal for the recognition of post-default additional drawings for non-retail exposures tis proportionate, as the proposal allows firms a choice about whether to reflect these in LGD or EAD estimates.
- The PRA considers that its proposal to remove its wholesale EAD framework is proportionate because when combined with other PRA proposals, for example moving exposures to institutions, financial corporates, and large corporates to the FIRB approach, retaining the wholesale EAD framework would add unnecessary complexity for limited prudential benefit.
- As a result of the above, the PRA considers that its overall package on EAD is proportionate.

2. Efficient and economic use of the PRA's resources (FSMA regulatory principles):

- The PRA considers that its proposals to restrict the scope of EAD modelling would reduce the amount of time and resources it spends reviewing models that are unlikely to be sufficiently robust. This would enable the PRA to focus its resources more efficiently.

3. Growth (HMT recommendation letters), finance for the real economy (FSMA CRR rules), and sustainable growth (FSMA regulatory principles):

- The PRA considers that the proposals set out in this section would improve the robustness of RWAs and would help to ensure that they more accurately reflect risk that firms take. This would help to ensure that firms are able to continue lending throughout the economic cycle and support sustainable growth.

4. Competitiveness (HMT recommendation letters) and relative standing of the UK as a place to operate (FSMA CRR rules):

- The PRA considers that most of proposals set out in this section support the competitiveness of the UK. The PRA proposes to broadly align with the Basel 3.1 standards on EAD modelling restrictions and to remove the PRA's existing wholesale EAD framework, which is super-equivalent to the Basel 3.1 standards. The PRA would expect other jurisdictions to take a similar approach to implementing the Basel 3.1 standards, supporting the UK's competitiveness and relative standing as the individual country regimes would become more closely aligned and there would be a more level playing field for firms that operate across them.

5. Relevant international standards (FSMA CRR rules):

- The PRA considers that the proposals set out in this section align with the Basel 3.1 standards. The proposed removal of the PRA's wholesale EAD framework, which is not part of the Basel 3.1 standards, would also increase alignment between the PRA's overall framework for EAD and the Basel 3.1 standards.

Maturity

4.303 This section sets out the PRA's proposals for calculating the maturity parameter which is used in the IRB risk weight formula for exposures to corporates and institutions.

Calculation of maturity

4.304 The CRR currently sets out two methods for firms that apply the FIRB approach can use to calculate maturity:

- a fixed parameter approach, where maturity is set at 0.5 years for certain short-term transactions and at 2.5 years for all other exposures; and
- an effective maturity approach, where firms calculate effective maturity according to prescribed formulae. If a firm is unable to calculate effective maturity under this approach, the contractual maturity is instead applied. A one-year floor applies to the maturity calculated for most transactions, but certain transactions are subject to a reduced maturity floor.

4.305 The PRA currently specifies within IRB permissions that firms using the FIRB approach must calculate effective maturity rather than apply fixed parameters. This is because the PRA considers that calculation of effective maturity is a more risk-sensitive approach, which better reflects the economic substance of the exposures, and thus enhances the safety and soundness of firms. Furthermore, using effective maturity facilitates effective competition because firms using the AIRB approach are also required to apply the effective maturity approach.

4.306 The PRA proposes to maintain the substance of its existing approach and that firms using the FIRB approach would continue to be required to apply the effective maturity approach. The PRA proposes to include this provision in its rules as it considers this would be more appropriate than applying the requirement on a firm-by-firm basis as is currently the case.

4.307 The PRA considers that the proposed approach is in line with the Basel 3.1 standards as these include a discretion for national supervisors to require firms using the FIRB approach to calculate effective maturity for all exposures.

4.308 Similarly, to improve risk-sensitivity, the PRA proposes to remove the option currently set out in the CRR that allows firms that are otherwise calculating maturity to instead apply fixed maturity values for exposures to small UK corporates.

Other proposals

4.309 The PRA also proposes to make the following additional minor changes to its requirements:

a. to align with the Basel 3.1 standards on the reduced maturity floors that apply to transactions in scope of master netting agreements by:

- restricting the scope of the reduced floors to those transactions where the documentation requires daily re-margining or revaluation and includes provisions allowing for prompt liquidation or set-off in the event of default or failure to re-margin. See Credit Risk: Internal Ratings Based Approach (CRR) Part;
- expanding the scope of the reduced floors to also apply a floor of 20 days for secured lending subject to a master netting agreement, and a floor of either 10 or 20 days for master netting agreements including more than one transaction type. See Credit Risk: Internal Ratings Based Approach (CRR) Part; and
  - specifying that in all such cases, the notional amount of each transaction would be used for weighting the maturity. See Credit Risk: Internal Ratings Based Approach (CRR) Part.

b. to clarify the definition of trade finance transactions that are in scope of a one-day maturity floor. See Credit Risk: Internal Ratings Based Approach (CRR) Part;

c. for revolving exposures, to clarify that effective maturity would be determined by using the maximum contractual termination date of the facility and that firms should not use the repayment date of the current drawing to estimate the effective maturity. This proposal is in line with the Basel 3.1 standards. See Credit Risk: Internal Ratings Based Approach (CRR) Part;

d. for purchased receivables, to align with the Basel 3.1 standards and require that the effective maturity would be a minimum of one year instead of the existing 90-day minimum. See Credit Risk: Internal Ratings Based Approach (CRR) Part;

e. for dilution risk of purchased receivables, clarify that effective maturity would be set at one year only if a firm could demonstrate that the dilution risk is appropriately monitored and could be resolved within one year. Otherwise, effective maturity should reflect the period over which dilution risk could be resolved, with a cap of five years. See Credit Risk: Internal Ratings Based Approach (CRR) Part; and

f. make consequential changes to those elements of the maturity calculation that reference the CVA framework, to reflect the new CVA rules proposed in this CP (see Chapter 7 – Credit valuation adjustment, and Credit Risk: Internal Ratings Based Approach (CRR) Part.

Question 31: Do you have any comments on the PRA's proposals for maturity?

PRA objectives analysis

4.310 The PRA considers that the proposed approach to maturity set out in this section would advance the PRA's primary objective of safety and soundness. The proposals would result in more risk-sensitive and more accurate estimations of effective maturity that reflect the economic substance of the exposures.

4.311 The PRA considers that the proposals set out in this section would facilitate effective competition. The proposals would retain the substance of the existing PRA approach whereby firms using both FIRB and AIRB approaches are expected to calculate effective maturity in a consistent manner, thus promoting a level playing field.

'Have regards' analysis

4.312 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Proportionality (FSMA regulatory principles and Legislative and Regulatory Reform Act 2006):

- The proposal for calculating effective maturity under the FIRB approach would be consistent with the PRA's existing approach and would be less burdensome for firms compared to implementing a new policy.

2. Relevant international standards (FSMA CRR rules):

- The PRA considers that its proposals relating to maturity would align with the Basel 3.1 standards, including through those national discretions in these standards that the PRA proposes to exercise.

3. Competitiveness (HMT recommendation letters) and relative standing of the UK as a place to operate (FSMA CRR rules):

- The PRA considers that allowing firms using the FIRB approach to continue calculating effective maturity would be positive for competitiveness and relative standing. The PRA considers that UK firms that use the FIRB approach would apply a more risk-sensitive approach and that the RWAs of these firms would better reflect the risk of exposures compared with jurisdictions that require use of a fixed parameter approach.

Specialised lending

4.313 This section sets out the PRA's proposals relating to the IRB approach for specialised lending exposures and the use of the slotting approach.

Specialised lending category definitions

4.314 Firms using the slotting approach currently allocate specialised lending exposures to one of the following categories:

- 'project finance';
- 'object finance';
- 'commodities finance'; and
- 'income producing real estate' (IPRE).

4.315 The Basel 3.1 standards contain a fifth category: 'high volatility commercial real estate (HVCRE)'. This category attracts higher risk weights under the slotting approach. The PRA proposes to introduce this category into its regime to introduce greater risk-sensitivity and to align with the Basel 3.1 standards.

4.316 The PRA proposes that the HVCRE category would encompass specialised lending secured on real estate that meets one or more of the following criteria:

a. the real estate is bought for speculative purposes;

b. a change of planning use is sought for the real estate; or

c. loans financing the land, acquisition, development, and construction of real estate where the source of repayment at origination of the exposure is either:

- the future uncertain sale of the real estate; or
- cash flows whose source of repayment is substantially uncertain, unless the borrower has sufficient equity to absorb most losses through the asset development and construction phase in a severe but plausible scenario.

4.317 The PRA proposes that this HVCRE definition would apply to the classification of all specialised lending exposures regardless of geographic location.

4.318 The PRA also proposes to introduce category definitions for project finance, object finance, commodities finance, and IPRE that would be broadly in line with the Basel 3.1 standards.

4.319 The PRA considers that HVCRE exposures typically exhibit higher loss rate volatility compared to other types of specialised lending and that HVCRE exposures should therefore receive higher risk weights than IPRE exposures for a given slotting assignment. While the proposal could increase RWAs for some exposures, the PRA would not expect the increase to be material in aggregate as the PRA assesses that HVCRE is unlikely to be a significant exposure class for most firms.

4.320 The PRA considers that the proposed introduction of HVCRE would enhance the risk-sensitivity of the slotting approach and would help ensure that a greater degree of risk-sensitivity is retained relative to the proposed specialised lending treatment in the SA. The PRA considers this would result in RWAs for specialised lending being more reflective of the risk of a firm's exposures. The PRA considers that the introduction of the HVCRE category would therefore promote the safety and soundness of firms.

Introduction of additional risk-sensitivity in the slotting approach

4.321 The PRA proposes to broadly align the risk-weighting treatment in the slotting approach with the Basel 3.1 standards.

4.322 Under the PRA's proposed slotting approach, which would align with the existing approach in the CRR, firms would assign specialised lending exposures to one of four categories: 'strong', 'good', 'satisfactory', and 'weak'. The assignment would be based on a set of defined factors and sub-factors (including financial strength, political and legal environment, and specific transaction characteristics) with the specific factors tailored to each specialised lending sub-class. Application of the factors would result in assignment of the lowest risk exposures to the strong category and assignment of the highest risk exposures to the weak category. Defaulted exposures would be assigned to the 'default' category. The PRA proposes to move existing material relating to the slotting factors and sub-factors from its expectations into PRA rules as requirements on firms.

4.323 Under the CRR, firms are permitted to apply a preferential slotting risk weight to exposures in the strong and good categories (a 50% risk weight instead of a 70% risk weight in the strong category, and a 70% risk weight instead of a 90% risk weight in the good category) if the remaining maturity of the exposure is less than 2.5 years. The CRR preferential treatment is more restrictive than the Basel 3.1 standards, as the latter gives national supervisors wider discretion to permit firms to apply the preferential risk weights in the strong and good categories if the exposures have 'substantially stronger' underwriting and other risk characteristics are met, even if the less than 2.5 years remaining maturity criteria is not met. The PRA considers that the existing approach to determining remaining maturity creates opportunities for firms to artificially structure loans such that the remaining maturity is less than 2.5 years so they could benefit from the lower risk weight.

4.324 The PRA therefore proposes to amend the circumstances in which preferential risk weights would be available for exposures assigned to the strong and good slotting categories, in order to introduce greater risk-sensitivity, address concerns with firms' current application of the remaining maturity criteria, and to align more closely with the scope of the Basel 3.1 standards. The proposed risk weights are set out in Table 4 below:

Table 4: Proposed slotting risk weights

	Strong		Good		Satisfactory	Weak	Default
	Preferential	Non-preferential	Preferential	Non-preferential			
Project / object / commodities finance and IPRE	50%	70%	70%	90%	115%	250%	0%
HVCRE	70%	95%	90%	120%	140%	250%	0%

4.325 For project finance, object finance, commodities finance, and IPRE, the PRA proposes to retain existing EL values but to align the preferential EL treatment with the preferential risk weight treatment set out above. For HVCRE, the PRA proposes to introduce ELs without a preferential treatment, in line with the Basel 3.1 standards. The proposed EL values are set out in Table 5 below:

Table 5: Proposed slotting expected loss values

	Strong		Good		Satisfactory	Weak	Default
	Preferential	Non-preferential	Preferential	Non-preferential			
Project / object / commodities finance and IPRE	0%	0.4%	0.4%	0.8%	2.8%	8%	50%
HVCRE	0.4%	0.4%	0.4%	0.4%	2.8%	8%	50%

4.326 The PRA proposes that firms would only assign the preferential risk weights in the strong and good categories if the exposure:

a. has less than 2.5 years remaining until maturity and the firm reasonably considers that the obligor could refinance the exposure in a severe but plausible stress in the refinancing market (see para 4.326); or

b. is an IPRE exposure and has features which are 'substantially stronger' than the criteria specified for the strong category (see para 4.327).

4.327 For (a), the PRA proposes to restrict application of the preferential risk weight to situations where the firm reasonably considers that the obligor would be able to be refinance the exposure in a severe but plausible stress in the refinancing market. The PRA considers this restriction is desirable in order to prevent exposures that would likely have a longer maturity in practice from being assigned a preferential risk weight.

4.328 For (b), the PRA proposes that the following criteria would all need to be met for the PRA to consider the exposure to be 'substantially stronger':

- the transaction is allocated to the strong slotting category for each slotting factor;
- the leverage of the obligor is substantially below the market norm for a similarly structured transaction in this sector, region, and of this property location and quality; and
- a substantial amount of the transaction's cash flows comes from investment grade (or equivalent) counterparties, with a minimum of 100% of the interest covered by income from investment grade or equivalent tenants.

4.329 The PRA considers that these proposals would result in a more risk-sensitive slotting approach. The PRA considers that the proposed introduction of the 'substantially stronger' category could encourage firms to increase lower risk lending. The PRA considers that the proposed changes are aligned with the Basel 3.1 standards and contain safeguards to prevent regulatory arbitrage.

Use of the slotting approach for IPRE and HVCRE exposures

4.330 The PRA considers, as currently set out in SS11/13, that it is difficult for firms to build effective and compliant IRB rating systems for IPRE exposures. As a result, most firms use the slotting approach for IPRE exposures.

4.331 Given that the PRA has not observed any strong evidence to suggest that firms can build effective rating systems for IPRE exposures, the PRA proposes that the option for firms to apply the AIRB or FIRB approaches for IPRE exposures would no longer be permitted. Firms currently using the IRB approach for IPRE exposures would instead be required to risk weight the exposures using the slotting approach.[26] The PRA proposes that this restriction would also apply to exposures that would be newly allocated to the HVCRE category.

4.332 The PRA considers that these proposals would contribute to improving the robustness of RWAs in capturing risk, given the persistent modelling challenges observed for these exposures, but would not result in a significant change in RWAs, given that these exposures are typically risk-weighted under the slotting approach already.

The general corporates and specialised lending boundary

4.333 The PRA would not propose to introduce further modelling restrictions for other categories of specialised lending. Therefore, the AIRB approach, the FIRB approach, and the slotting approach would continue to be available for the project finance, object finance, and commodities finance categories. This contrasts with the proposed approach for other corporate exposures whereby the AIRB approach for exposures to institutions, financial corporates, and large corporates would be withdrawn and the exposures would move to the FIRB approach.

4.334 The PRA recognises that its proposals could potentially give rise to regulatory arbitrage whereby firms could choose to allocate certain exposures to either the other general corporates exposure sub-class or the specialised lending exposure sub-class in order to optimise RWAs.

4.335 The PRA would therefore intend to monitor firms' allocation of large corporate exposures between the other general corporates exposure sub-class and the specialised lending exposure sub-class. The PRA's monitoring would assess whether firms apply the proposed definitions correctly and whether exposures are allocated to the specialised lending exposure sub-class only if the specialised lending criteria are fully met.

4.336 The PRA proposes to prohibit firms from reflecting credit protection which is recognised under the risk weight substitution method in their assignment of exposures to slotting categories in order to prevent double counting (see Chapter 5 for further information regarding the PRA's proposal to permit use of the risk weight substitution method for exposures subject to the slotting approach).

Other specialised lending proposals

4.337 Firms are currently only able to use the slotting approach where they cannot build a compliant specialised lending PD model. The PRA proposes that, provided they could comply with relevant requirements, firms would be able to adopt the slotting approach for exposures in the project finance, object finance, and commodities finance categories, regardless of whether they are able to build a compliant PD model. The proposed requirements for slotting IPRE and HVCRE are discussed in the 'Specialised lending category definitions' section above. See Credit Risk: Internal Ratings Based Approach (CRR) Part.

4.338 The PRA proposes to set expectations regarding the broad correspondence of external credit ratings to each slotting category in order to align with the Basel 3.1 standards. These would complement but not replace the existing slotting criteria, which the PRA proposes that firms would continue to apply. The expected loss based 'external credit assessment institution' (ECAI) ratings that the PRA proposes would broadly correspond to each slotting category are set out in the Table 6 below. See Credit Risk: Internal Ratings Based Approach (CRR) Part.

Table 6: Correspondence of ECAI ratings to slotting categories

<table>
<tr><th rowspan="2"></th><th colspan="2">Strong</th><th rowspan="2">Good</th><th rowspan="2">Satisfactory</th><th rowspan="2">Weak</th><th rowspan="2">Default</th></tr>
<tr><th>Substantially stronger</th><th>Not substantially stronger</th></tr>
<tr><td>IPRE</td><td>BBB+ or better</td><td>BBB or BBB-</td><td rowspan="2">BB+ or BB</td><td rowspan="2">BB- or B+</td><td rowspan="2">B to C-</td><td rowspan="2">Not applicable</td></tr>
<tr><td>Specialised lending excluding IPRE</td><td colspan="2">BBB- or better</td></tr>
</table>

Question 32: Do you have any comments on the PRA's proposals for specialised lending?

PRA objectives analysis

4.339 The PRA considers that the proposals set out in this section would advance the PRA's primary objective of safety and soundness. The PRA considers that the proposed introduction of a HVCRE specialised lending category would promote the safety and soundness of firms as HVCRE exposures typically exhibit higher loss rate volatility than IPRE exposures, and so the PRA considers that these exposures should be assigned higher risk weights for a given slotting category. The PRA considers that the proposed introduction of the HVCRE category and the proposed introduction of preferential risk weights for certain specialised lending exposures would enhance the risk-sensitivity of slotting, which would result in RWAs that better correspond to the underlying risk. The PRA considers that the proposed requirement to apply the slotting approach to IPRE and HVCRE exposures would also promote safety and soundness of firms by improving the robustness of RWAs, given the PRA considers it challenging for firms to model these exposures robustly.

4.340 The PRA considers that the proposals set out in this section would have a broadly neutral impact on its secondary objective of facilitating effective competition. The proposals for HVCRE would mainly impact firms that have riskier IPRE exposures. For non-real estate specialised lending exposures, the PRA would expect the proposals would have the greatest impact on the business lines of large firms in which they are less likely to directly compete with smaller firms, so the PRA would not expect the proposals set out in this section to materially impact effective competition between large and small firms.

'Have regards' analysis

4.341 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Proportionality of costs and benefits (FSMA regulatory principles and Legislative and Regulatory Reform Act 2006):

- The PRA considers that the proposals set out in this section are a proportionate response to the identified deficiencies in IRB modelling of specialised lending exposures. The proposed introduction of new exposure class and exposure sub-class definitions could create some initial costs for firms when amending their internal systems but the PRA considers they would not generate increased costs over time.

2. Competitiveness (HMT recommendation letters) and relative standing of the UK as a place to operate (FSMA CRR rules):

- The PRA considers that the proposals could have some implications for UK competitiveness. The PRA considers that the proposed mandating of slotting for IPRE and HVCRE exposures would not materially change the UK's relative standing as most UK firms already apply the slotting approach for IPRE. The proposal to introduce an HVCRE category aligns with the Basel 3.1 standards, but the PRA recognises that some international jurisdictions may not introduce this category and relevant UK firms could be required to apply a higher risk weight to these exposures in the UK, all else equal, than in other jurisdictions. However, the PRA considers that introducing the HVCRE category and associated slotting risk weights is prudentially justified as the PRA considers HVCRE to be the most volatile type of specialised lending. The PRA would expect that the proposed changes to the criteria for applying preferential risk weights would have a mixed impact on the UK's relative standing. This is because the PRA proposes a more restrictive approach than under the CRR for applying lower risk weights based on the 'less than 2.5 years remaining maturity criteria', but also proposes to allow lower risk weights for certain IPRE exposures that meet the 'substantially stronger' criteria.

3. Relevant international standards (FSMA CRR rules):

- The PRA considers that the proposed introduction of a new HVCRE category and the proposed approach to risk-weighting exposures under the slotting approach are aligned with the Basel 3.1 standards. The PRA considers that the proposal to require application of the slotting approach to IPRE and HVCRE exposures is more restrictive than the Basel 3.1 standards. However, the PRA considers this proposal to be justified for safety and soundness considerations given the challenges in modelling these exposures.

4. Efficient and economic use of PRA resources (FSMA regulatory principles):

- The PRA considers that the proposals would result in an efficient and economic use of PRA resources. This is particularly the case for the proposal to require firms to use the slotting approach for IPRE and HVCRE exposures as the PRA would not need to review models that it considers are unlikely to be robust or materially compliant with its rules.

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1. The CRR and PRA rules use the term 'exposure classes' whereas the Basel 3.1 standards typically use the term 'asset classes'. References to exposure classes in this CP should be read as having the same meaning as asset classes in the Basel 3.1 standards.

2. See Chapter 2 – Scope and levels of application, which also describes the position for PRA-designated financial holding companies or mixed financial holding companies related to those UK banks and building societies.

3. The PRA expects all permissions granted under CRR Article 143(1), 148(1), 150(1) and 162(2)(h) to be saved by HMT for firms implementing the Basel 3.1 standards. This would result in permissions granted under CRR Articles 143(1), 148(1), 150(1) and 162(2)(h) being deemed to be permissions under Rule 1.1 and Article 143(1), Articles 148(1) and

148(1A), Article 150(1) and Article 162(2)(h) of the Credit Risk: Internal Ratings Based Approach (CRR) Part. See paragraph 4.19 for further details on CRR Article 143(1) permissions and paragraph 4.91 for further details on CRR Article 148(1) and CRR Article 150(1) permissions. For TCR firms see paragraph 2.26 of Chapter 2.

4. 'IRB roadmap' refers to the policy set out in PRA Policy Statement 7/19 – '**Credit risk: The definition of default**'; March 2019 on the definition of default and PRA Policy Statement 11/20 – '**Credit risk: Probability of Default and Loss Given Default estimation**', May 2020 on PD and LGD estimation.

5. This was communicated bilaterally to firms.

6. The PS must first be published in 'near final' form as HMT need to issue a Statutory Instrument to revoke relevant parts of the CRR before final PRA rules can be made. Material changes between the near-final and final rules would not be expected.

7. Changes to the model submission timetable were communicated bilaterally to firms.

8. See PRA Consultation Paper 21/19 | Policy Statement 11/20 – '**Credit risk: Probability of Default and Loss Given Default estimation**', May 2020.

9. This would include applications to move exposures from the SA to the IRB approach, from the FIRB approach to the AIRB approach, or from the slotting approach to the FIRB approach or the AIRB approach.

10. Commission Delegated Regulation (EU) No 529/2014 (as onshored in the UK) for assessing the materiality of extensions and changes of the Internal Ratings Based Approach and the Advanced Measurement Approach.

11. As proposed in Chapter 13 – Currency Redenomination, to reflect the €500 million threshold stated in the Basel 3.1 standards.

12. As proposed in Chapter 13 – Currency Redenomination, to reflect the €1 million threshold stated in the Basel 3.1 standards.

13. The PRA would amend saved IRB permissions to require firms to apply the SA to central government and central bank exposures from 1 January 2025, as outlined in paragraph 4.19.

14. The PRA would amend saved IRB permissions to require firms to apply the FIRB approach to exposures to institutions, financial corporates, and large corporates to which they currently apply the AIRB approach from 1 January 2025, as outlined in paragraph 4.19.

15. The PRA would amend saved IRB permissions to require firms to apply the SA to equity exposures from 1 January 2025, as outlined in paragraph 4.19. Transitional arrangements for risk-weighting equity exposures that are outlined in the CP would be set out in the Credit Risk: General Provisions Part of the PRA Rulebook.

16. See CRR Article 150.

17. The Prudential Sourcebook for Banks, Building Societies and Investment Firms as it existed on or before 31 December 2013.

18. The analysis assumes a corporate SME maturity = 2.5 years, LGD = 25%, no 1.06 IRB scaling factor and no application of the SME support factor. An illustrative LGD of 25% has been used to reflect an SME portfolio with a mix of secured and unsecured exposures. However, the PRA recognises that LGD estimates may be higher for certain exposures, including unsecured SME exposures. At higher LGDs, the size adjustment would result in a higher absolute decrease in risk weights.

19. Measured on both an exposure value and RWA basis.

20. Conversion factors are an input into the calculation of EAD for off-balance sheet items.

21. For more details on this method, see Chapter 5 – Credit risk mitigation.

22. **EBA/RTS/2016/03 Final Draft Regulatory Technical Standards on the specification of the assessment methodology for competent authorities regarding compliance of an institution with the requirements to use the IRB Approach in accordance with Articles 144(2), 173(3), and 180(3)(b) of Regulation (EU) No 575/2013**.

23. These are the same haircuts as proposed in the foundation collateral method.

24. **Reducing variation in credit risk-weighted assets - constraints on the use of internal model approaches - consultative document.**

25. The PRA would amend saved IRB permissions to require firms using the AIRB approach to apply these restrictions on EAD modelling from 1 January 2025, as outlined in paragraph 4.19.

26. The PRA would amend saved IRB permissions to require firms to apply the slotting approach to all IPRE and HVCRE exposures to which they currently apply the FIRB approach or the AIRB approach from 1 January 2025, as outlined in paragraph 4.19.

Appendices

- Appendix 4: Draft PRA Rulebook (CRR) Instrument [2023] (PDF 4.1MB)
- Appendix 12: Draft amendments to Supervisory Statement 13/16 – Underwriting Standards for Buy-to-Let Mortgage Contracts (PDF 1.4MB)
- Appendix 13: Draft Supervisory Statement – Credit Risk Internal Ratings Based Approaches (PDF 1.8MB)
- Appendix 14: Draft Supervisory Statement – Credit Risk Definition of Default (PDF 1.6MB)

Previous chapter Next chapter

CP16/22 – Implementation of the Basel 3.1 standards: Credit risk mitigation

Chapter 5 of CP16/22

Published on 30 November 2022

Content

Overview

5.1 This chapter sets out the Prudential Regulation Authority's (PRA) proposals to implement the Basel 3.1 standards for credit risk mitigation (CRM), and to amend the PRA's expectations in respect of CRM. The proposals set out in this chapter are relevant to firms using the standardised approach (SA) and the internal ratings based (IRB) approach to credit risk. The proposals relating to the 'financial collateral comprehensive method' (FCCM) volatility adjustments are also relevant to firms using the standardised approach to counterparty credit risk (SA-CCR).

5.2 The proposals in this chapter would:

- complement HM Treasury's (HMT) proposed revocation of certain Capital Requirements Regulation (CRR) articles;
- introduce a new Credit Risk Mitigation (CRR) Part of the PRA Rulebook;
- insert an additional provision into the Counterparty Credit Risk (CRR) Part of the PRA Rulebook;
- amend Supervisory Statement (SS)17/13 'Credit risk mitigation' (Appendix 15); and
- amend SS12/13 'Counterparty credit risk' (Appendix 17).

5.3 CRM is a series of techniques used by a firm to reduce the credit risk associated with an exposure or exposures that the firm continues to hold. The CRR allows firms to reflect two forms of eligible CRM in their risk-weighted assets (RWA):

- funded credit protection (FCP): a type of CRM that reflects financial or non-financial collateral held against an exposure, which the firm can retain or liquidate in case of the default of a borrower or counterparty. It also includes the use of on-balance sheet netting and master netting agreements (MNA); and
- unfunded credit protection (UFCP): a type of CRM that reflects the promise from a third party to pay when a borrower or counterparty defaults.

5.4 Throughout this chapter, the PRA refers to the following CRM methods outlined in Table 1 below:

Table 1: CRM methods referenced in this chapter

CRM method	Description
On-balance sheet netting	A method for recognising on-balance sheet netting under all approaches to credit risk, which the PRA proposes to restrict to recognition through exposure value only.
Financial collateral simple method (FCSM)	A method for recognising financial collateral, which can only be used by firms applying the SA.
Financial collateral comprehensive method (FCCM)	A method for recognising financial collateral, which the PRA proposes would only be available for (a) exposures that give rise to credit risk (other than derivatives) under all credit risk approaches, and (b) exposures that do not give rise to credit risk under the SA only.[1] Firms are currently able to model the volatility adjustments used within this method if they have permission from the PRA; however, the PRA proposes to withdraw this option.
Foundation collateral method	A proposed new method for recognising financial and non-financial collateral, which the PRA proposes to introduce for firms using the foundation internal ratings based (FIRB) approach and which would replace existing similar methods.
Other funded credit protection (OFCP) method	A bespoke method for recognising other funded credit protection under the SA and the FIRB approach, which the PRA proposes to retain.
LGD modelling collateral method	A method for firms using the advanced internal ratings based (AIRB) approach to recognise the effects of financial and non-financial collateral in loss given default (LGD) estimates.
Securities financing transactions value-at-risk (SFT VaR) method (previously known as the 'internal models approach for master netting agreements')	A method for calculating the exposure value of SFTs, which firms may apply subject to PRA permission. The method currently applies to exposures covered by MNAs only; however, the PRA proposes to extend it to also cover single transactions.
Internal models method (IMM)	A method for modelling exposure value for derivatives and SFTs in accordance with counterparty credit risk requirements.[2]
Risk weight substitution	A method that involves substituting the risk weight of the exposure with that of

method	the protection provider to reflect the effect of UFCP, which the PRA proposes would be applied to all exposures subject to the SA, and to exposures subject to the FIRB and AIRB approaches where comparable direct exposures to the protection provider[3] would be subject to the SA. The PRA proposes to extend this method to exposures subject to the slotting approach in certain circumstances.
Parameter substitution method	A method that involves substituting probabilities of default (PDs) and, optionally, FIRB LGD values, of the exposure with those of the protection provider to reflect the effect of UFCP. This method is applied by firms using the FIRB and AIRB approaches where they are not applying the risk weight substitution method or, for AIRB approaches, the LGD adjustment method.
LGD adjustment method	A method that involves firms making adjustments to modelled LGD values to reflect the effect of UFCP. The PRA proposes to restrict this approach to exposures subject to the AIRB approach where comparable direct exposures to the protection provider are also subject to the AIRB approach.
Obligor grade adjustment	A method for reflecting the effect of protection arrangements in IRB PD models, by making adjustments to obligor grades, which is not considered to be a CRM method (see Chapter 4 – Credit risk – internal ratings based approach).
PD adjustment	A method of adjusting PD estimates under the FIRB and the AIRB approaches to reflect CRM, which the PRA proposes to withdraw.
Double default approach	A method for recognising the effect of UFCP in the IRB risk weight formula, which the PRA proposes to withdraw.

5.5 The Basel Committee on Banking Supervision (BCBS) identified the following weaknesses in the existing Basel standards, including, in relation to CRM:

- unnecessary complexity in the framework that could result in excessive variability in RWAs;[4] and
- the ability of firms to use internal estimates under the SA, which is contrary to one of the BCBS's principles for revising the SA.[5]

5.6 To enhance the clarity and consistency of the CRM framework, and to address these weaknesses, the Basel 3.1 standards introduce a number of material changes impacting the treatment of FCP and UFCP under both the SA and the IRB approach.

5.7 The PRA supports the changes to the CRM framework that are set out in the Basel 3.1 standards. The PRA considers that the changes would improve the robustness, consistency and comparability of the use of CRM across firms and therefore proposes a number of changes to the CRM framework that are consistent with the Basel 3.1 standards.

5.8 The PRA considers that CRM is a complex part of the RWA framework, and therefore proposes certain additional amendments which the PRA considers would reduce complexity, improve coherence, and provide greater clarity to firms regarding the availability of CRM methods.

5.9 The PRA sets out a number of proposals relating to FCP in this chapter that are consistent with the Basel 3.1 standards. Key proposals include:

- under the SA, removal of certain methods for calculating the effects of FCP and amendments to the methods that remain available;
- under the FIRB approach, amendments to existing methods for calculating the effects of FCP, including new supervisory LGD values and collateral volatility adjustments; and
- under the AIRB approach, a new technique for calculating the effects of FCP where firms lack sufficient data.

5.10 The PRA also sets out a number of proposals relating to UFCP in this chapter that are consistent with the Basel 3.1 standards. Key proposals include:

- restrictions on existing methods where firms adjust PDs and/or obligor grades in IRB models; and
- new restrictions on recognising and modelling UFCP which would depend on the credit risk approach applicable to comparable direct exposures to the protection provider.

5.11 The proposals in this chapter are relevant to PRA-authorised banks, building societies, PRA-designated investment firms, and PRA-approved or PRA-designated financial holding companies or mixed financial holding companies (‘firms’). The proposals would not apply to UK banks and building societies that meet the Simpler-regime criteria and choose to be subject to the Transitional Capital Regime proposals.[6]

5.12 In this chapter, the PRA has set out details of its proposals where it proposes substantive changes to requirements and expectations relative to the existing approach. The PRA also proposes to make a number of other amendments in order to enhance the clarity and coherence of the framework. This includes consolidating some existing PRA rules into new Rulebook Parts. To the extent that the PRA does not propose to amend the existing approach, existing requirements and expectations would continue to apply.[7]

Methods for recognising CRM

5.13 This section sets out the PRA's proposals relating to the availability of methods for recognising CRM. Further proposals relating to the application of the CRM methods themselves are set out in subsequent sections.

Overview

5.14 As set out in the chapter overview, the Basel 3.1 standards introduce a number of material changes to the CRM framework in order to reduce excessive variability of RWAs.

5.15 The PRA proposes to introduce three frameworks of methods for recognising CRM based on the nature of the credit protection and the credit risk approach applied to the exposures. The first framework would cover recognition of FCP for exposures that give rise to counterparty credit risk, the second framework would cover recognition of FCP for exposures that do not give rise to counterparty credit risk, and the final framework would cover recognition of UFCP.

5.16 The most significant changes proposed by the PRA relating to the availability of methods for recognising CRM include:

- withdrawal of the option to use own-estimate volatility adjustments in the FCCM for firms using all credit risk approaches (FCCM with use of supervisory volatility adjustments would remain available);
- restricting the use of the internal models approach for master netting agreements to firms using the FIRB and AIRB approaches and extending this approach to cover single transactions, in addition to the existing scope of transactions subject to MNAs (renamed as the 'SFT VaR method');
- introduction of a new integrated approach to collateral recognition for firms using the FIRB approach, which would incorporate and update existing methods for recognising financial and non-financial collateral (the foundation collateral method);
- introduction of new restrictions on the availability of methods for recognising the effect of UFCP, based on the credit risk approach that would be applied to comparable exposures to the protection provider, as well as the credit risk approach that applies to the exposure itself; and
- withdrawal of the 'double default' approach for recognising the effect of UFCP in the IRB approach.

5.17 The PRA proposes to clarify that firms may choose to disregard CRM across all credit risk approaches and CRM methods.

5.18 The application of CRM methods by firms using the IRB approach is subject to risk weight floors as specified in the Basel 3.1 standards. Further details of the PRA's proposals relating to these floors are set out in Chapter 4.

5.19 The PRA proposes to introduce a rule requiring firms which would recognise both FCP and UFCP in respect of the same exposure to do so in an appropriate manner that is consistent with the frameworks for recognising FCP and UFCP that are set out in this chapter.

5.20 The PRA proposes to clarify in the Credit Risk Mitigation (CRR) Part that the review that firms are required to undertake to confirm the legal effectiveness and enforceability of CRM must be repeated as necessary to help ensure ongoing enforceability.

Funded credit protection: exposures that give rise to counterparty credit risk

5.21 The PRA considers that the existing interaction between the requirements in the Credit risk mitigation chapter of the CRR, the Counterparty credit risk chapter of the CRR, and the Counterparty Credit Risk (CRR) Part is excessively complex. This can lead to uncertainty as to which methods are available to firms, resulting in the inconsistent application of methods across firms. It can also result in opportunities for firms to 'cherry-pick' methods in order to reduce RWAs.

5.22 With the aim of simplifying the framework, the PRA proposes the following framework of methods for FCP recognition for exposures that give rise to counterparty credit risk (the proposed framework is summarised in Chart 1 below):

- for derivative exposures, the PRA proposes to retain existing methods with no changes (regardless of the approach to credit risk used). Derivative exposures would continue to be subject to the requirements currently set out in the Counterparty credit risk chapter of the CRR and the Counterparty Credit Risk (CRR) Part;
- for SFTs and any other exposures within the scope of an IMM permission, FCP would only be recognised in accordance with the IMM (regardless of the approach to credit risk used);
- the internal models approach for master netting agreements would be renamed the 'SFT VaR method'.[8] For exposures within the scope of an SFT VaR method permission, FCP would only be recognised in accordance with that method. The SFT VaR method would not be available where firms are applying the SA as set out in paragraph 5.25;
- for all other exposures that give rise to counterparty credit risk and that are subject to the SA, FCP would be recognised by either adjusting risk weights in accordance with the FCSM or by adjusting exposure values in accordance with the FCCM. Firms using the FCSM would not be permitted to recognise MNAs and would instead treat each exposure subject to a MNA as a single transaction; and
- for all other exposures that give rise to counterparty credit risk that are subject to the IRB approach, FCP would be recognised by adjusting exposure values in line with the FCCM.

Use of own-estimate volatility adjustments within FCCM

5.23 The PRA proposes to withdraw the use of own-estimate volatility adjustments within FCCM for all firms, which would align with the Basel 3.1 standards. The PRA proposes that all firms using FCCM instead use specified supervisory volatility adjustments.

5.24 For exposures subject to the SA, the proposed withdrawal of own-estimate volatility adjustments is intended to eliminate this aspect of modelling from the SA credit risk framework. This is because the PRA considers firms using the SA generally find it challenging to develop robust own-estimate volatility adjustment models within the FCCM. For exposures subject to the IRB approach, the PRA does not consider it necessary to retain own-estimate volatility adjustments within FCCM, because of its proposals relating to the SFT VaR method that are set out below.

SFT VaR method

5.25 The PRA proposes that the SFT VaR method would not be available for exposures subject to the SA, because the PRA considers that firms using the SA generally find it challenging to develop robust SFT VaR method models. The PRA does not propose any changes to the availability of the IMM, which would align with the Basel 3.1 standards.

5.26 The PRA proposes to extend the SFT VaR method to also cover single transactions, to align with the Basel 3.1 standards, in order to replace the use of own-estimate volatility adjustments within FCCM for firms using the IRB approach.

Recognition in exposure value and risk weights

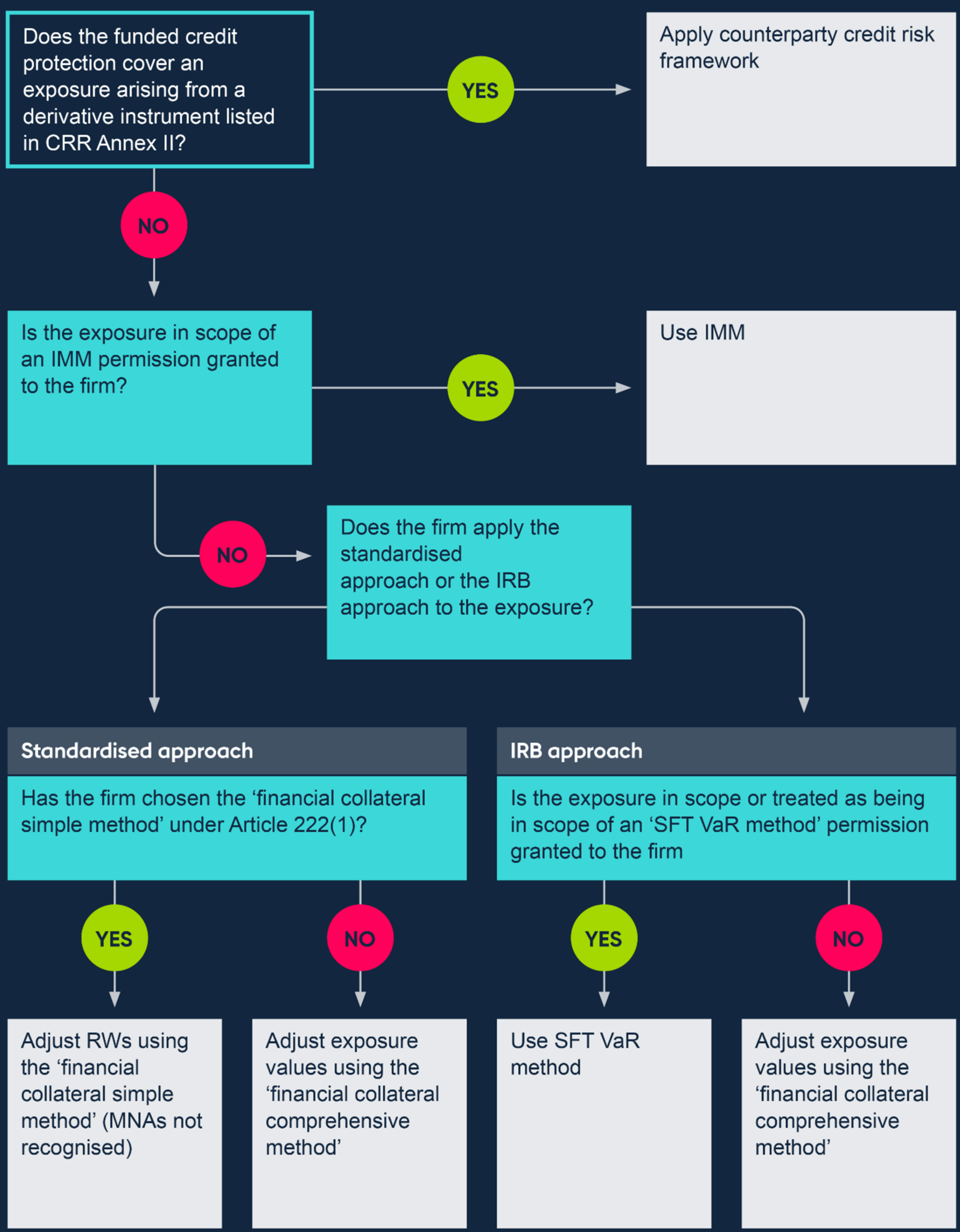
5.27 The PRA considers that the overall effect of the proposals in this section would be that, with the exception of firms applying the FCSM, firms would only be able to recognise FCP for exposures that give rise to counterparty credit risk through adjustments to the exposure value. This would represent a change to the existing position, where firms can recognise FCP through adjustments to LGD in some circumstances, including through AIRB models.

5.28 The PRA considers that adjusting the exposure value is generally the most appropriate mechanism for recognising FCP where exposures give rise to counterparty credit risk. But the PRA also considers that it is appropriate for firms using the SA to continue to be able to use the FCSM to adjust risk weights for such exposures. Firms would need to make a single choice between the FCSM and the FCCM for all exposures on SA, as explained in paragraph 5.33.

Summary of proposed framework

5.29 The proposed framework for recognition of FCP on exposures that give rise to counterparty credit risk is outlined in the chart below:

Chart 1: Summary of the proposed framework for recognition of FCP on exposures that give rise to counterparty credit risk



Question 33: Do you have any comments on the PRA's proposals for recognising FCP for exposures that give rise to counterparty credit risk?

Funded credit protection: exposures that do not give rise to counterparty credit risk

5.30 The PRA considers that there is currently excessive complexity in the CRM framework for recognition of FCP in respect of exposures that do not give rise to counterparty credit risk (eg secured loans).

5.31 The PRA proposes that, in order to simplify the framework, the following methods would apply where firms choose to recognise CRM for exposures that do not give rise to counterparty credit risk (the proposed framework is summarised visually in Chart 2 below):

- on-balance sheet netting would be recognised through adjustments to exposure value only under the SA and IRB approach. The PRA proposes to clarify the mechanics of how on-balance sheet netting impacts exposure value calculations;
- for exposures subject to the SA:
  - financial collateral would be recognised by either adjusting risk weights in accordance with the FCSM or by adjusting exposure values in accordance with the FCCM. Firms would be required to make a single choice between the FCSM and the FCCM for all exposures subject to the SA, as explained in paragraph 5.33 of this section;
  - non-financial collateral would continue to not be recognised in the CRM framework, however certain SA risk weights would continue to reflect the existence of non-financial collateral (eg the SA risk weights for immovable property); and
  - collateral that is currently classed as OFCP would continue to be recognised under a standalone method. The PRA proposes to refer to this as the ‘OFCP method’;
- for exposures subject to the FIRB approach:
  - financial and non-financial collateral would be recognised by an integrated method for adjusting LGD values known as the ‘foundation collateral method’. This method would align with the FCCM for financial collateral and replace existing foundation LGD values for non-financial collateral. Further details about the PRA’s proposals for the foundation collateral method is set out in ‘Funded credit protection’ section; and
  - collateral in the form of OFCP would be recognised using the OFCP method;
- for exposures subject to the AIRB approach, firms would continue to reflect financial and non-financial collateral using the LGD modelling collateral method. Use of alternative CRM methods to recognise financial and non-financial collateral, such as those available for exposures subject to the SA or the FIRB approach, would not be permitted; and
- for exposures subject to the slotting approach, collateral would not be recognised via the CRM framework but would instead continue to be reflected in the assignment of exposures to slotting categories.

Use of own-estimate volatility adjustments in the FCCM

5.32 The PRA proposes to withdraw the option for firms to use own-estimate volatility adjustments in the FCCM for exposures that do not give rise to counterparty credit risk, in line with the approach for exposures that give rise to counterparty credit risk set out above. The PRA does not propose, however, to introduce any alternatives for modelling volatility adjustments in the FCCM for exposures not subject to counterparty credit risk under either the SA or the FIRB approach. This would align with the Basel 3.1 standards, and reflects the complexity of modelling in this area. The FCCM with use of supervisory volatility adjustments would remain available.

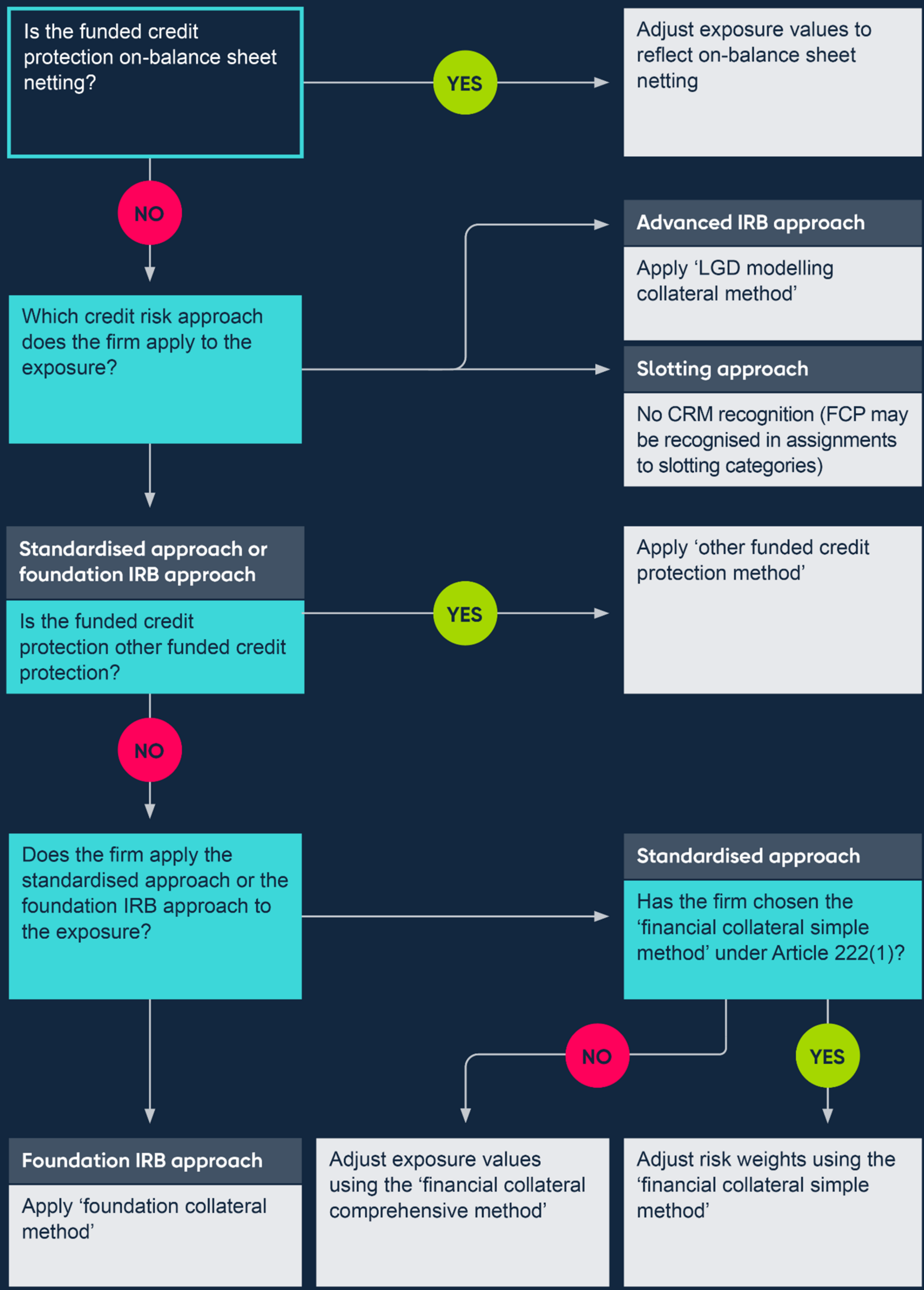
Use of the FCSM and the FCCM

5.33 The PRA proposes to continue to permit firms using the SA to make a choice between either applying the FCSM or the FCCM for all exposures. The PRA also proposes to clarify that firms with IRB permissions that use the SA for certain exposures would also be required to make a choice between these two methods for all exposures subject to the SA.

Summary of proposed framework

5.34 The PRA considers that the proposals in this section would bring clarity to the framework and would reduce 'cherry-picking' opportunities. The proposed framework for recognition of FCP on exposures that do not give rise to counterparty credit risk is outlined in the chart below:

Chart 2: Summary of the proposed framework for recognition of FCP on exposures that do not give rise to counterparty credit risk



Question 34: Do you have any comments on the PRA's proposals for recognising FCP for exposures that do not give rise to counterparty credit risk?

Unfunded credit protection

5.35 The PRA proposes to introduce the following framework of methods for recognising UFCP (the proposed framework is summarised visually in Chart 3 below):

- for exposures subject to the SA, UFCP would continue to be recognised by the 'risk weight substitution method';
- for exposures subject to the FIRB approach:
  - if a comparable direct exposure to the protection provider would be subject to the SA, UFCP would be recognised by the 'risk weight substitution method'; and
  - if a comparable direct exposure to the protection provider would be subject to the FIRB approach or the AIRB approach, UFCP would be recognised by the 'parameter substitution method' (PD substitution plus optional FIRB LGD substitution as further detailed in the 'Unfunded credit protection' section of this chapter);
- for exposures subject to the AIRB approach:
  - if a comparable direct exposure to the protection provider would be subject to the SA, UFCP would be recognised by the 'risk weight substitution method';
  - if a comparable direct exposure to the protection provider would be subject to the FIRB approach, UFCP would be recognised by the 'parameter substitution method' as set out above; and
  - if a comparable direct exposure to the protection provider would be subject to the AIRB approach, UFCP would either be recognised by:
    - the 'LGD adjustment method', where firms make adjustments to modelled LGD values to reflect the credit protection; or
    - the 'parameter substitution method' as set out above; and
- for exposures subject to the slotting approach, the PRA proposes to introduce recognition of UFCP using the 'risk weight substitution method' in certain circumstances.

Consistency in use of method

5.36 In order to reduce 'cherry-picking' opportunities, the PRA also proposes that where firms have a choice of UFCP methods, they would be required to apply the same method to all guarantees and credit derivatives of a particular type. The PRA proposes that firms would be required to have a documented policy in place to determine which UFCP method applies to each type of guarantee or credit derivative.

Dependency on the credit risk approach used for the protection provider

5.37 The PRA considers it appropriate that the proposals link the availability of UFCP methods to the credit risk approach that would apply to a comparable direct exposure to the protection provider, because it considers that it can be challenging for firms to model the impact of credit protection provided by an entity where the PRA considers that they are unable to model direct exposures to that entity. The PRA is seeking, through its proposals, to provide greater clarity on which CRM methods are available in cases where a comparable direct exposure to a protection provider is subject to a different credit risk approach than approach applied to the exposure on which the credit protection has been received.

Risk weight substitution method

5.38 The PRA considers that its proposals for the methods available for UFCP recognition would not result in any change for exposures currently subject to the SA, as firms already use the risk weight substitution method for these exposures.

5.39 The PRA proposes, however, to extend the use of the risk weight substitution method to exposures subject to the slotting approach in certain circumstances. Firms would only be able to use this method in respect of exposures that benefit from UFCP that meet the CRM eligibility criteria. Certain other indirect support, such as guarantees of cash flows, would continue to be reflected as part of the assignment of exposures to slotting categories subject to restrictions to prevent double counting (see Chapter 4 for further details).

Interaction of methods for recognising UFCP

5.40 The PRA proposes to withdraw a CRM technique that allows firms using the IRB approach to make adjustments to PD estimates. However, PD substitution would still be permitted. The PRA considers these proposals are justified as there is currently considerable complexity in how PD adjustments interact with both LGD adjustments and adjustments to obligor grades in IRB models. The PRA considers that the current complexity on these interactions could result in unwarranted variation in RWAs, as firms are able to take different approaches.

5.41 However, as set out in Chapter 4, ‘Probability of default (PD) estimation’ section, the PRA proposes to continue to permit firms to make adjustments to obligor grades in the IRB models themselves to reflect documented support arrangements. Such adjustments, which would not fall within the scope of the CRM framework, would enable firms to continue to reflect such support arrangements in PD estimates where a full PD substitution is not warranted.

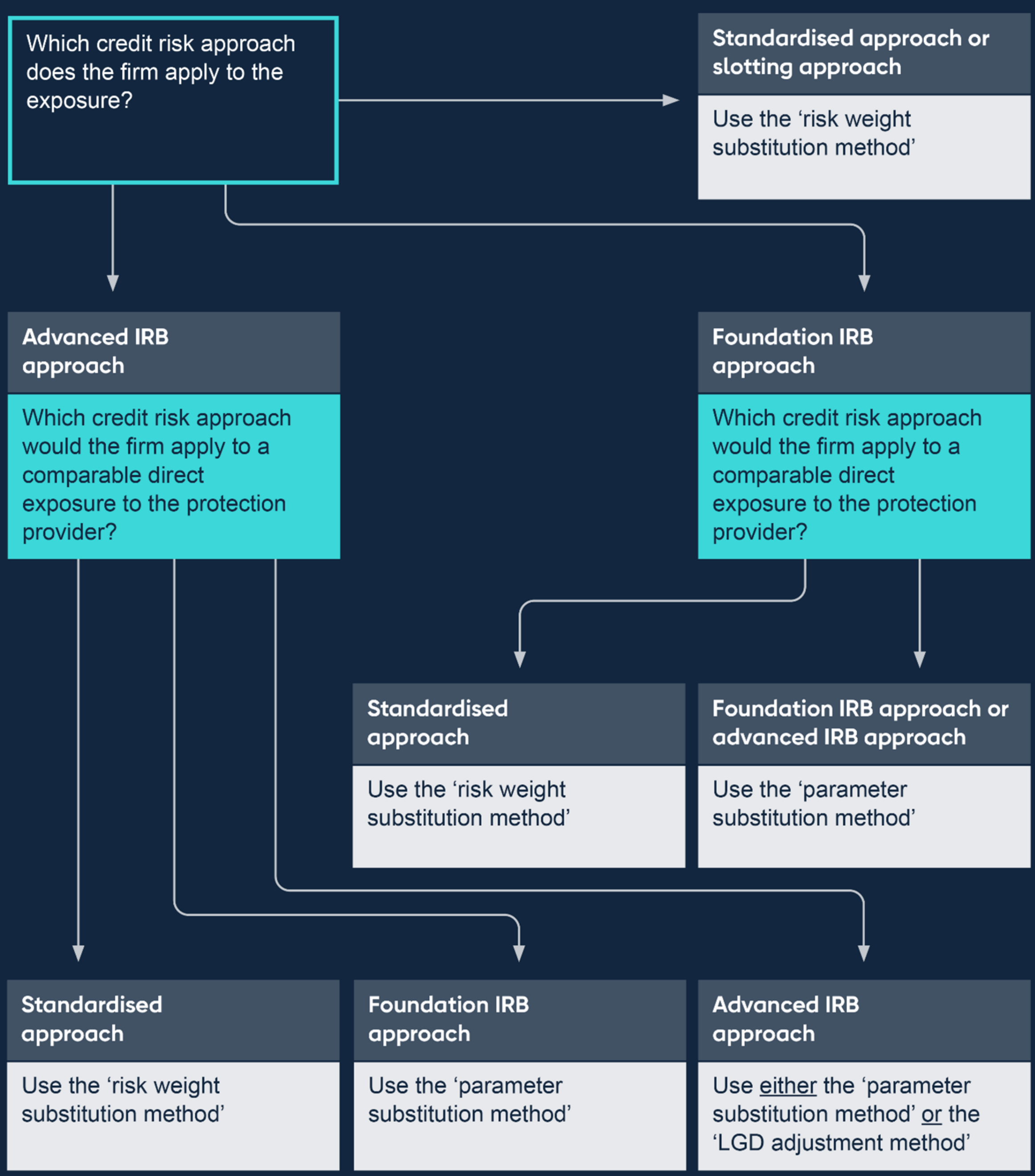
5.42 Where an exposure is subject to the AIRB approach and a comparable direct exposure to the protection provider would also be subject to the AIRB approach, the PRA proposes that firms would be able to: (a) continue to recognise UFCP through adjustments to LGD models (the 'LGD adjustment method'), or (b) alternatively apply the parameter substitution method, which would align with the Basel 3.1 standards. The PRA considers that this proposal would provide an alternative recognition method for firms that are unable to model the effect of the credit protection.

5.43 The PRA proposes to withdraw the 'double default' approach for recognising credit protection, which would align with the Basel 3.1 standards. The PRA considers that it is appropriate to withdraw this approach in order to reduce unnecessary complexity and risk weight variability in the CRM framework.

5.44 The PRA proposes to introduce a number of further restrictions on how the various CRM methods and modelling techniques interact. Further details are set out in the 'Unfunded credit protection' section of this chapter.

5.45 The proposed framework for recognition of UFCP is outlined in the chart below:

Chart 3: Summary of the proposed framework for recognition of UFCP



Question 35: Do you have any comments on the PRA's proposals for recognising UFCP?

PRA objectives analysis

5.46 The PRA considers that the proposals set out in this section would advance its primary objective of safety and soundness. Limiting opportunities for firms to use internal modelling approaches that are not sufficiently robust should reduce the potential for firms to achieve RWA reductions in respect of CRM that are not commensurate with the CRM's risk-mitigating effect. Reducing the number of options in the CRM framework would result in more consistent and comparable CRM approaches being applied across firms which should, in turn, improve the consistency, comparability, and credibility of RWAs across firms.

5.47 The proposals set out this section may result in changes to RWAs for some firms that currently use CRM modelling approaches that the PRA proposes to remove. The impact of these proposed changes depends on the conservatism of a firm's modelled RWAs compared to RWAs calculated under the proposed remaining approaches. The PRA considers there would be some overall increase in RWAs due to the proposed restrictions on modelling, but that this would be likely to vary materially across firms and across exposure and transaction types, since RWAs would decrease in some cases. The PRA considers that such changes to RWAs would be consistent with its primary objective, as the proposals would help ensure that the risks to which firms are exposed are prudently capitalised.

5.48 The PRA considers that the proposals set out in this section would advance the PRA's secondary objective of facilitating effective competition. The proposed restrictions would have the effect of narrowing the gap in RWAs between firms using the IRB approach and firms using the SA, resulting in a more level playing field across firms.

'Have regards' analysis

5.49 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Relevant international standards (FSMA CRR rules):

- The PRA considers that the proposals set out in this section are broadly aligned with the Basel 3.1 standards. There is some potential ambiguity regarding the availability of CRM methods in the Basel 3.1 standards, and the PRA has sought to propose an implementation of the standards that would reduce unwarranted variation in risk weights and minimise uncertainty for firms.

2. Competitiveness (HMT recommendation letters) and relative standing of the UK as a place to operate (FSMA CRR rules):

- The PRA has not identified any adverse impact on the competitiveness of the UK arising from the proposals set out in this section. While there is some uncertainty regarding the approach that may be taken by other regulators, the PRA expects that proposals of a broadly similar nature are likely to be adopted in most major jurisdictions.

3. Sustainable growth (FSMA regulatory principles) and growth (HMT recommendation letters):

- The PRA considers that the proposals set out in this section would support sustainable growth. Providing greater clarity and certainty on the interaction of CRM methods and the approaches to modelling credit risk may provide firms with more confidence to engage in economic activities. Restricting the availability of CRM methods may cause increases in RWAs in some circumstances; however, if RWAs do increase, this may benefit sustainable growth to the extent that RWAs are currently too low relative to risk.

4. Transparency (FSMA regulatory principles and Legislative and Regulatory Reform Act 2006):

- The PRA considers that its proposals to clarify available CRM methods would contribute to the transparency of regulatory activities. Providing more clarity on the available CRM methods and their application should make it easier for firms and other stakeholders to understand and apply the PRA's regulatory framework.

5. Proportionality (FSMA regulatory principles and Legislative and Regulatory Reform Act 2006):

- The PRA considers that the proposals set out in this section would be a proportionate response to deficiencies in the existing CRM framework that have been identified by the BCBS and the PRA. The PRA considers its proposals to be proportionate as they simplify the CRM framework, while retaining a range of methods for the recognition of CRM which should limit the impact of the proposed restrictions. This is because firms would have alternative methods available to recognise CRM, and benefit from RWA reductions where appropriate.

Funded credit protection

5.50 This section sets out a number of proposed changes to the following aspects of the FCP framework:

- the FCCM;

- SFT VaR method permissions;
- the foundation collateral method;
- treatment of trading book instruments used as collateral for SFTs;
- minor changes relating to eligible forms of collateral;
- minor changes relating to collateral eligibility requirements; and
- minor changes relating to the treatment of FCP in RWA calculations.

5.51 The proposed availability of FCP methods is set out in the ‘Methods for recognising CRM’ section of this chapter.

The financial collateral comprehensive method

Changes to the FCCM volatility adjustments

5.52 The PRA proposes a series of changes to the FCCM supervisory volatility adjustments.[9] The PRA considers these proposed changes are relevant for firms applying the foundation collateral method, the alternative methodology in the LGD modelling collateral method, and for firms calculating LGD input floors, because the FCCM supervisory volatility adjustments are used as inputs in each of these cases.[10]

5.53 The PRA proposes to make the volatility adjustments that currently apply under the CRR more risk-sensitive. The size of the existing volatility adjustments depends on the type of collateral, the credit quality step, and the residual maturity of the collateral.[11] The existing volatility adjustments are scaled using a prescribed formula when a liquidation period[12] other than 10 days is prescribed. A five-day liquidation period is prescribed for repurchase transactions (with certain exceptions) and securities lending and borrowing, while a 20-day liquidation period is prescribed for secured lending transactions.[13]

5.54 The PRA considers that the proposed changes to volatility adjustments is unlikely to have a material impact on overall RWAs. However, as an illustration, where the PRA proposes that residual maturity buckets would be split in two, with decreased volatility adjustments for shorter maturities and maintained or increased adjustments for longer maturities, the PRA considers that the effect would be to make the volatility adjustments increase more smoothly as maturity increases while the overall level of calibration would remain broadly unchanged. In this way, the PRA is seeking to introduce more risk-sensitivity, rather than to increase or decrease the conservatism of the calibration.

5.55 The PRA does not propose changes to volatility adjustments applicable to debt securities that are issued by central governments and central banks, or for collateral that are securitisation positions. In respect of debt securities issued by entities other than central governments and central banks, the PRA proposes changes to volatility adjustments that are set out in Table 2 below:

Table 2: Volatility adjustments for debt securities

Credit quality step (CQS)	Maturity (*m*)	Current	Proposed
CQS 1	$m \leq$ one year	1%	1%
	One year < $m \leq$ three years	4%	3%
	Three years < $m \leq$ five years	4%	4%
	Five years < $m \leq$ ten years	8%	6%
	m > ten years	8%	12%
CQS 2-3	$m \leq$ one year	2%	2%
	One year < $m \leq$ three years	6%	4%
	Three years < $m \leq$ five years	6%	6%
	Five years < $m \leq$ ten years	12%	12%
	m > ten years	12%	20%

5.56 The PRA also proposes changes to the volatility adjustments for equities and convertible bonds as set out in Table 3 below:

Table 3: Volatility adjustments for equities and convertible bonds

Exposure	Current	Proposed
Main index equities (including convertible bonds)	15%	20%
Other equities and convertible bonds listed on a recognised exchange	25%	30%

5.57 The PRA proposes that the volatility adjustments in both Tables 2 and 3 above would apply to exposures with a 10-day liquidation period, and that the volatility adjustments required for five-day and 20-day liquidation periods would be scaled accordingly.

5.58 The PRA does not propose to amend the existing approach where the liquidation periods used are brought in line with those set out in the Counterparty credit risk chapter of the CRR in certain circumstances.

5.59 The PRA proposes to clarify that in instances where an equity investment in a collective investment undertaking (CIU) is used as collateral, and the firm would apply the look-through approach to calculating the risk weight for a direct exposure to the CIU, the applicable volatility adjustment would be a weighted average of the volatility adjustments applicable to the CIU's exposures.

5.60 Firms can currently apply a 0% volatility adjustment when certain conditions are met. The PRA proposes to specify additionally that the 0% volatility adjustment would only be applied where firms have an unfettered, enforceable right to immediately seize and liquidate collateral following default. This would align with the Basel 3.1 standards. The PRA proposes this additional restriction because it considers that application of a 0% volatility adjustment is imprudent where a firm does not have a legal right to immediately seize and liquidate the collateral.

Changes to the FCCM formula for SFTs subject to eligible MNAs

5.61 Firms using the FCCM can currently apply a formula that allows them to reflect the effect of eligible MNAs across multiple SFTs, rather than treating each SFT as an individual collateralised transaction. The Basel 3.1 standards introduce a revised formula that aims to increase risk-sensitivity and better account for diversification and correlation.

5.62 Aligning with the Basel 3.1 standards, the PRA proposes to implement the following revised formula:

$$E^* = \max\left\{0, \left[\sum_i E_i - \sum_j C_j + 0.4 \cdot E_{net} + 0.6 \cdot \frac{E_{gross}}{\sqrt{N}} + \sum_k \left|E_k^{fx}\right| \cdot H_k^{fx}\right]\right\}$$

where:

- E* is the exposure value of the exposures subject to the MNA after CRM;
- i is the index that denotes all separate securities, commodities or cash positions under the agreement, that are either lent, sold with an agreement to repurchase, or posted by the institution to the counterparty;

- j is the index that denotes all separate securities, commodities or cash positions under the agreement that are either borrowed, purchased with an agreement to resell, or held by the institution;
- k is the index that denotes all separate currencies in which any securities, commodities or cash positions under the agreement are denominated;
- E_i is the exposure value of a given security, commodity, or cash position i, that is either lent, sold with an agreement to repurchase or posted to the counterparty under the agreement that would apply in the absence of the credit protection. This calculation would exclude securities or commodities where: (i) the net position is negative; and (ii) the securities or commodities are not eligible CRM;
- C_j is the value of a given security, commodity, or cash position j that is either borrowed, purchased with an agreement to resell, or held by the institution under the agreement. This calculation would exclude securities or commodities where: (i) the net position is negative; and (ii) the securities or commodities are not eligible CRM;
- E_k^{fx} is the net position (positive or negative) in a given currency k other than the settlement currency of the agreement;
- H_k^{fx} is the foreign exchange volatility adjustment for currency k;
- E_{net} is the net exposure of the agreement, calculated as follows:

$$E_{net} = \left| \sum_{m=1} E_m^{SEC} \cdot H_m^{SEC} \right|$$

where:

- E_m^{SEC} is the net position (positive or negative) in a given group of securities m, or a given type of commodities m, under the agreement; and
- H_m^{SEC} is the volatility adjustment appropriate to a given group of securities m, or a given type of commodities m; and
- E_{gross} is the gross exposure of the agreement, calculated as follows:

$$E_{gross} = \sum_{m=1} E_m^{SEC} \cdot |H_m^{SEC}|$$

and

- N is the number of distinct groups of the same securities and distinct types of the same commodities under the MNA (except that groups and types where the value E_m^{SEC} is less than one tenth of the value of the largest E_m^{SEC} in the netting set are not included the count).

5.63 The PRA proposes to limit eligibility of MNAs under the FCCM to those MNAs that would allow for the prompt liquidation or set-off of collateral upon the event of default, to align with the Basel 3.1 standards. As a result, firms would not be able to use this formula in respect of MNAs that do not meet this criterion. The PRA considers that this proposal would increase the robustness of the regulatory framework.

5.64 Both the existing and proposed revised formulae effectively contain three components:

a) the current exposure;

b) an add-on to reflect potential price changes of the securities covered by the MNA; and

c) an add-on to reflect any currency mismatches of the securities covered by the MNA.

5.65 The proposed revised formula would effectively change the second component from being calculated entirely on a gross basis, to being partially calculated on a net basis and partially calculated on a gross basis. The gross element would be adjusted based on the number of material security issuances covered by the MNA. The PRA considers that the proposed revised formula would result in a more risk-sensitive approach for these transactions and risks, as it would allow some recognition of both netting and diversification.

5.66 The PRA proposes to clarify that where firms post ineligible collateral, this would be reflected in the same way as any other posted collateral, with a 30% volatility adjustment applied. The PRA proposes that where firms receive ineligible collateral, this would be disregarded within the FCCM formula.

SFT VaR method permissions

5.67 For firms using the IRB approach, the PRA proposes to make a number of changes relating to SFT VaR method permissions:

a) to provide that SFT VaR method permissions may be granted where firms 'materially comply', instead of fully comply with the conditions, in line with the proposed changes to the IRB approach (see Chapter 4);

b) to introduce a requirement in the Credit Risk Mitigation (CRR) Part that firms wishing to use the SFT VaR method by virtue of an internal models approach (IMA) permission must first notify the PRA, and to clarify that in such cases firms may only apply the SFT VaR method for products within the scope of the IMA permission;

c) to introduce a requirement in the Credit Risk Mitigation (CRR) Part that firms wishing to make material extensions and changes to SFT VaR method permissions would need to seek the prior approval of the PRA, except where the SFT VaR method is used solely by virtue of an IMA permission in which case pre-notification would be required;

d) to introduce an expectation that all other changes would need to be post-notified to the PRA on a quarterly basis;

e) to make a number of changes to its expectations regarding the classification of extensions and changes to SFT VaR method permissions (see Appendix 17);

f) to require that firms using the SFT VaR method, but which do not meet the requirements for using that method, notify the PRA and either submit a remediation plan to address the non-compliance in a timely manner or demonstrate to the PRA that the effect of the non-compliance is immaterial (see the Credit Risk Mitigation (CRR) Part); and

g) to make a number of further related changes to its expectations regarding SFT VaR method permissions and SFT VaR method annual attestations (see Appendix 17).

5.68 The PRA considers that these proposed changes to the SFT VaR method permission process would deliver a more coherent regulatory framework, provide greater clarity to firms on the processes relating to SFT VaR method permissions and increase alignment with the IRB permissions framework.

5.69 The PRA also proposes to introduce three new requirements relating to the SFT VaR method, namely:

- a requirement that ineligible collateral received should be excluded from the calculation of net current exposure and from the VaR calculations within the SFT VaR method, in line with the proposed approach under the FCCM;
- that MNAs would only be recognised where they allow for the prompt liquidation or set-off of collateral upon the event of default in line with the proposed approach under the FCCM;

and

- an additional qualitative standard that firms' systems for managing risks arising from transactions covered by eligible MNAs are conceptually sound and implemented with integrity.

The foundation collateral method

5.70 As noted above, the PRA proposes to introduce a revised methodology known as the foundation collateral method, which would be available to firms using the FIRB approach. The PRA considers that its proposed specification of this method is also relevant to firms using the 'LGD modelling collateral method' (see Chapter 4, section 'Loss given default (LGD) estimation') and firms calculating LGD input floors (see Chapter 4, section 'Input floors') because the PRA proposes that both of these would make use of the foundation collateral method formulae.

5.71 The proposal would combine existing approaches for financial and non-financial collateral into a single formula for cases where the firm recognises a single type of collateral, and a further formula where the firm recognises multiple types of collateral.

5.72 The PRA proposes that the following formula would be used where a firm recognises a single type of collateral:

$$\mathrm{LGD}^{*} = \mathrm{LGD_U} \cdot \frac{\mathrm{E_U}}{\mathrm{E} \cdot (1 + \mathrm{H_E})} + \mathrm{LGD_S} \cdot \frac{\mathrm{E_S}}{\mathrm{E} \cdot (1 + \mathrm{H_E})}$$

where:

- LGD* is the LGD applicable to a collateralised transaction;
- LGD_U is the FIRB unsecured LGD applicable to the exposures;
- LGD_S is the foundation collateral method secured LGD applicable to the collateral type (as set out in Table 4 below);
- E is the current value of the exposure after the effect of on balance sheet netting;
- E_U is the value of unsecured exposure calculated as follows:

$$\mathrm{E_U} = \mathrm{E} \cdot (1 + \mathrm{H_E}) - \mathrm{E_S}$$

- E_S is the current value of the collateral after the application of the applicable volatility adjustment (H_C);

- H_C is the volatility adjustment applied to the collateral (as defined in the FCCM for financial collateral and in the foundation collateral method for non-financial collateral – see Table 4 below); and
- H_E is the volatility adjustment applicable to the exposure.

5.73 The PRA proposes that, where a firm receives multiple types of collateral for a single exposure, it would apply a formula that would have the effect of repeatedly applying the formula for a single type of collateral in line with the Basel 3.1 standards. The effect of the proposed formula would be to divide each exposure into portions reflecting each type of recognised collateral as well as an unsecured portion where applicable. In line with the proposed formula for recognising a single type of collateral, the total adjusted value of the secured portions of the exposure would be capped at the adjusted total value of the exposure ($E (1 + H_E)$). The proposed formula for multiple types of collateral would be specified as follows:

$$\mathrm{LGD}^* = \mathrm{LGD_U} \cdot \left(\frac{\mathrm{E_U}}{\mathrm{E} \cdot (1 + \mathrm{H_E})}\right) + \sum_i \mathrm{LGD_{S_i}} \cdot \left(\frac{\mathrm{E_{S_i}}}{\mathrm{E} \cdot (1 + \mathrm{H_E})}\right)$$

where:

- i is the index of all the separate types of collateral obtained for that exposure;
- $\mathrm{LGD_{S_i}}$ is the foundation collateral method secured LGD applicable to the collateral of type i;
- $\mathrm{E_{S_i}}$ is the current value of the collateral of type i received after the application of the volatility adjustment applicable for the type of collateral (H_C) (as set out in Table 4 below);
- E_s is the current value of the collateral received after the application of volatility and maturity mismatch adjustments;
- H_c for the first piece of collateral recognised by the firm (where i = 1), the following definition would apply:

$$\mathrm{E_{S_1}} = \min\{\mathrm{C_1}, \mathrm{E} \cdot (1 + \mathrm{H_E})\}$$

- for all subsequent pieces of collateral recognised by the firm (where i ≥ 2), the following definition would apply:

$$E_{S_i} = \min\left\{C_i , E \cdot (1 + H_E) - \sum_{k=1}^{i-1} E_{S_k}\right\}$$

- k is the index that denotes all separate values of the index ;
- E_U is the value of unsecured exposure calculated as follows:

$$E_U = E \cdot (1 + H_E) - \sum_i E_{S_i}$$

and

- all other terms are as defined in the previous formula for when a firm recognises a single type of collateral.

5.74 The proposed formulae would require firms to split secured exposures into one or more secured parts (one for each recognised type of collateral) based on volatility-adjusted collateral values, and a further unsecured part (in cases where the total volatility-adjusted value of the collateral is less than the value of the exposure). The formulae would then require firms to apply prescribed LGD values to the secured and unsecured parts.

5.75 The PRA considers that the Basel 3.1 standards do not specify a specific treatment where an item of collateral is held against multiple facilities. The PRA proposes to require firms to sub-divide such collateral into one or more portions prior to allocating these portions to specific facilities in order to prevent the effect of such collateral from being double counted. The PRA does not propose requirements or expectations regarding how firms allocate such collateral to specific facilities.

5.76 Firms applying the FCCM are currently required to 'gross up' exposure values for securities lent or posted by applying a volatility adjustment (H_E) to the value of the exposure. The PRA proposes to retain this approach in the foundation collateral method and extend its application to non-financial assets lent or posted in line with the Basel 3.1 standards.

5.77 Firms applying the FIRB approach are currently subject to minimum collateralisation requirements which need to be met to recognise the effect of non-financial collateral in the FIRB approach for a given exposure. As a result, collateral below the minimum levels cannot be recognised even where it has a risk-mitigating effect. The PRA proposes to remove these minimum collateralisation levels in order to enhance the risk-sensitivity of the framework in line with the Basel 3.1 standards.

5.78 Firms applying the FIRB approach are also currently subject to separate minimum collateralisation requirements that are needed for an exposure to be treated as fully collateralised. Where these minimum requirements are not met, the exposure is divided into a secured and unsecured part in an analogous way to the proposed new foundation collateral method formulae. The PRA considers that it is therefore unnecessary to retain these minimum collateralisation requirements as they are effectively superseded, so the PRA proposes to remove them.

5.79 The PRA proposes to make a number of revisions to secured LGD values and volatility adjustments in line with the Basel 3.1 standards. The PRA has set out a comparison of the existing regime and its proposals in Table 4 below. For this purpose, the PRA has calculated the effective volatility adjustment which is implied by the existing minimum collateralisation requirements so that a meaningful comparison can be made.

Table 4: Proposed changes to supervisory LGD values, required minimum levels of collateral, and volatility adjustments under FIRB

Type of collateral	Proposed secured LGD	Current secured LGD (senior exposures)	Current secured LGD (subordinated exposures)	Proposed volatility adjustment	Effective volatility adjustment (existing regime)
Eligible financial collateral	0%	0%	0%	Same volatility adjustments as used for the FCCM	Same volatility adjustments as currently used for the FCCM
Eligible receivables	20%	35%	65%	40%	20%
Eligible residential real estate / commercial real estate	20%	35%	65%	40%	28.6%
Other eligible physical collateral	25%	40%	70%	40%	28.6%

5.80 The proposed changes set out in Table 4 would increase volatility adjustments and reduce secured LGDs for all non-financial collateral types. The PRA considers that the overall effect of the proposals would increase the risk-sensitivity of the framework.

5.81 As set out in Table 4, firms currently apply different secured LGDs for senior and subordinated exposures. The PRA proposes that secured LGDs would no longer depend on the degree of subordination of the exposure and that the degree of subordination would continue to be reflected in the unsecured LGD applied to any unsecured part of the exposure. The PRA considers this to be an appropriate way to reflect the effects of subordination in LGD estimates.

Treatment of trading book instruments used as collateral for SFTs in the trading book

5.82 Firms applying the Counterparty credit risk chapter of the CRR to SFTs in the trading book are currently permitted to use a wider range of collateral than set out in the Credit risk mitigation chapter of the CRR. In particular, firms may treat all financial instruments and commodities that are eligible to be included in the trading book as eligible collateral, even if the firm does not currently trade them. The PRA considers that this diverges from the existing Basel standards, which only extend eligibility to instruments that are actually in the trading book.

5.83 The PRA considers that the existing approach in the CRR is likely to be imprudent, as it can result in collateral being recognised as eligible that the PRA considers firms would not always be able to liquidate in practice. The PRA therefore proposes to limit this treatment to financial instruments and commodities that are in the trading book, in line with the existing Basel standards.

Eligible forms of collateral

5.84 The PRA proposes the following series of minor changes to eligible forms of collateral:

a) to clarify that all firms may apply on-balance sheet netting where there is a currency mismatch between the exposure and collateral, subject to the application of the applicable volatility adjustment, in line with the Basel 3.1 standards;

b) firms are currently able to treat investment firms as institutions when determining whether financial collateral is eligible. The PRA proposes to replace this approach by amending the eligibility criteria such that collateral issued by financial institutions which are risk-weighted as institutions under the SA would be treated in the same way as collateral issued by institutions. The PRA considers that this would result in a more consistent framework for collateral recognition and would result in entities only being treated as institutions where they are subject to comparable prudential regimes;

c) for firms using the FIRB approach, the PRA proposes to implement new provisions on the recognition of general security agreements that are set out in the Basel 3.1 standards. These would explicitly clarify that firms may recognise collateral that is covered by a general security agreement or other forms of floating charge;

d) for firms using the SA or the FIRB approach, the PRA proposes to restrict the scope of cash assimilated instruments that can be recognised as eligible collateral to only those issued by the lending institution, in line with the Basel 3.1 standards. The PRA considers that cash assimilated instruments issued by entities other than the lending institution do not typically have the same CRM properties as cash deposits; and

e) for firms using the FIRB approach, the PRA proposes to limit the eligibility of receivables to those where repayment would be funded by the commercial or financial flows relating to the underlying assets of the counterparty, in line with the Basel 3.1 standards.

Collateral eligibility requirements

5.85 In respect of collateral eligibility requirements that apply to firms using the SA or the FIRB approach, the PRA proposes that firms may treat collateral associated with undrawn facilities, but which has not yet been received by the firm, as eligible where it otherwise satisfies all other eligibility requirements, and where drawing on the facility would be conditional on the prior or simultaneous purchase or receipt of the collateral by the firm.

5.86 In respect of collateral eligibility requirements which would apply to firms using the FIRB approach (and in some cases indirectly to firms using the AIRB approach as set out in paragraph 5.87 of this section), the PRA proposes the following minor changes:

a) to introduce two additional collateral management requirements for real estate and other physical collateral. The PRA proposes that firms would be required to monitor the extent of any permissible prior claims on an ongoing basis, and to monitor the risk of environmental liability in respect of the collateral. The PRA considers these proposed requirements would help ensure firms manage the risk that collateral valuations do not fully reflect these risks. Both proposed requirements would align with the Basel 3.1 standards;

b) to introduce a requirement that property valuations should be reviewed when a ‘default event’ occurs, in line with the Basel 3.1 standards, in order to provide for sufficiently robust valuations;[14]

c) to align with the Basel 3.1 standards by requiring that other non-financial collateral would only be eligible under the FIRB approach where the periodic revaluation process includes physical inspection of the collateral;

d) to simplify the existing process for derogating from a collateral eligibility requirement for real estate that requires that the risk of the borrower does not materially depend upon the performance of the underlying property or project. The PRA proposes to replace the existing derogations with a rule that applies this eligibility requirement to commercial real estate but not residential real estate;

e) to clarify that the valuations of real estate and other non-financial collateral required to meet eligibility criteria under the FIRB approach would need to be undertaken by qualified professionals. This would align with the Basel 3.1 standards;

f) to clarify that the legal review confirming the enforceability of collateral arrangements for receivables would need to be undertaken on an ongoing basis where necessary to confirm continuing enforceability;

g) to further specify the eligibility requirements for receivables relating to monitoring, to align with the Basel 3.1 standards (including in relation to the type of information that would need to be monitored and the monitoring of concentration limits); and

h) to introduce additional eligibility requirements for financial receivables linked to commercial transactions such that repayment would need to occur through commercial or financial flows relating to the underlying assets of the obligor.

5.87 The proposed changes set out in paragraphs 5.85 and 5.86 could also impact firms using the AIRB approach to the extent that they are required to establish internal processes that are generally consistent with those that apply under the FIRB approach in order to recognise collateral under the LGD modelling collateral method.

Treatment of FCP in RWA calculations

5.88 The PRA proposes the following minor changes to RWA calculations:[15]

a) firms using the SA and applying the FCSM must currently meet a number of conditions in order to apply a 0% risk weight floor for SFTs, to align with the conditions for applying a 0% volatility adjustment under FCCM. The PRA proposes that its proposed additional condition relating to the ability of the firm to immediately seize and liquidate the collateral in the event of the bankruptcy or insolvency of the counterparty, as outlined in the ‘Changes to the FCCM volatility adjustments’ sub-section, would also apply to firms applying a 0% risk weight floor under the FCSM. This would align with the Basel 3.1 standards;

b) for firms using the IRB approach, the PRA proposes to clarify that the same collateral eligibility criteria apply under the SFT VaR method as apply under the FCCM, which would align with the Basel 3.1 standards;

c) for firms using the FIRB approach, to remove references to mortgage lending value which the PRA considers to be not relevant in the UK, and to clarify the treatment of prior claims in immovable property valuation;

d) for firms using the FIRB approach, the PRA proposes to introduce an option for firms to value other physical collateral at less than its market value (the existing requirements state that other physical collateral must be valued at its market value);

e) firms using the FIRB approach are currently permitted to apply a 50% risk weight for parts of certain exposures collateralised by real estate as an alternative CRM treatment. The PRA proposes to remove this treatment, which would not align with the Basel 3.1 standards, because it does not consider it to reflect the risk or be prudentially justified;

f) for firms using the SA or the FIRB approach and applying the OFCP method, the PRA proposes a minor clarification regarding the application of the OFCP risk weight treatment for eligible cash assimilated instruments;

g) for firms using the SA or the FIRB approach and applying the OFCP method, the CRR sets out risk weights for exposures collateralised by the current surrender value of life insurance policies pledged to the lender. This involves mapping the applicable risk weights in the SA for exposures to the entity providing the life insurance. The PRA proposes to update the mapping to reflect the proposed changes to SA risk weights set out in Chapter 3 – Credit risk – Standardised approach, while retaining the existing OFCP method capital treatment;[16]

h) the PRA proposes to explicitly align the risk weight calculation under the OFCP method for collateral treated as guarantees with the risk weight treatment applied to guarantees. The eligibility criteria for OFCP recognition would, however, remain unchanged (and would not depend on the credit risk treatment for comparable direct exposures to the guarantor); and

i) the PRA also proposes to make a small number of minor changes to the approach for reflecting maturity mismatches in the CRM framework that are applicable to UFCP and FCP.

Question 36: Do you have any comments on the PRA’s proposals for FCP?

PRA objectives analysis

5.89 The PRA considers that the proposals set out in this section would increase the consistency, robustness, and risk-sensitivity of the FCP treatment in the CRM framework, thereby advancing its primary objective of safety and soundness. The proposed changes to volatility adjustments and supervisory LGDs in the FCCM would result in a prudent and risk-sensitive calibration of risk weights. The PRA considers that the proposed foundation collateral method formula would be more transparent than the current approach and would enhance comparability across firms, advancing the PRA's primary objective of safety and soundness. The PRA considers that the proposed revised LGD values and volatility adjustments in this method would provide a greater incentive to firms to take collateral that mitigates risks, while also maintaining prudent levels of RWAs to reflect remaining risks. The PRA considers that this would contribute to the safety and soundness of firms.

5.90 The PRA considers that the impact of the proposals set out in this section on firms' RWAs would be mixed. The proposed changes to the FCCM volatility adjustments should reduce RWAs for exposures with collateral of shorter maturities, and the proposed changes to the FCCM formula for SFTs with MNAs should result in lower RWAs to the extent that it better takes account of diversification. The proposal to remove the minimum collateralisation requirement for firms applying the FIRB approach to recognise the effect of non-financial collateral should allow greater recognition of collateral and result in a potential reduction in RWAs. The proposed lower LGD values for secured exposures under the foundation collateral method should also reduce RWAs. The changes to the recognition of trading book instruments as collateral for trading book SFTs may increase RWAs in cases where previously recognised collateral can no longer be recognised. Overall, the PRA considers that the net impact of the different proposals in this section would likely result in a slight reduction in aggregate RWAs; however, the PRA considers the impacts would differ across firms, as well as across different exposures and transactions.

5.91 The PRA considers that its proposals would facilitate effective competition between firms by reducing excessive variability in RWAs and providing greater consistency and comparability of RWAs and approaches across firms. For some transactions, compared to the existing framework, the proposals may favour firms using the IRB approach relative to the SA, whereas for others the proposals may favour firms applying the SA. The PRA also considers that the effect on competition between firms applying the FIRB approach and firms applying the AIRB approach would be broadly neutral.

'Have regards' analysis

5.92 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Relevant international standards (FSMA CRR rules):

- The PRA considers that the proposed changes in this section are broadly aligned with the Basel 3.1 standards. The PRA considers that some aspects of the Basel 3.1 standards are open to interpretation, and has therefore made proposals that it considers would implement the Basel 3.1 standards in line with its statutory objectives and 'have regards'.

2. Relative standing of the UK as a place to operate (FSMA CRR rules) and competitiveness (HMT recommendation letter):

- The PRA considers its proposals relating to the FCCM and the foundation collateral method to be broadly aligned with those expected to be introduced by other jurisdictions. The PRA also considers that the proposed clarifications to the existing approaches would support the UK's relative standing. The PRA considers that while the proposed changes to the recognition of trading book instruments as collateral for SFTs in the trading book would align with existing international standards, other jurisdictions may not implement this approach. The PRA considers that this could negatively impact the UK's relative standing; however, it does not consider the impact of this to be material.

3. Proportionality (FSMA regulatory principles and Legislative and Regulatory Reform Act 2006):

- The PRA considers that the proposals relating to the FCCM and the foundation collateral method would impact RWAs, but should not significantly impact operational costs. The proposed changes to the recognition of trading book instruments used as collateral for SFTs in the trading book may increase firms' operational costs, because firms would have to monitor trading book composition on an ongoing basis in order to confirm CRM eligibility. The proposed new volatility adjustments, the proposed new formula for SFTs with MNAs within the FCCM, and the proposed revised secured LGD values for non-financial collateral would be considered by the PRA to reduce RWAs. Overall, the PRA considers that its proposals are proportionate because, while they may increase firm's operational costs to some degree, the PRA considers the proposals to result in RWAs that better reflect risks.

4. Finance for the real economy (FSMA CRR rules):

- The PRA considers that its proposals relating to the FCCM would be unlikely to have a material impact on finance for the real economy. The PRA considers that the improved recognition of netting and collateral diversification in the proposed revised formula for SFTs with MNAs within the FCCM would support provision of financing by firms in the market for repurchase agreements. The proposed revised volatility adjustments and secured LGD values that would apply under the foundation collateral method may have a positive impact on firms' willingness to lend for certain types of transactions that use non-financial collateral. The proposed changes to collateral eligibility for SFTs in the trading book would increase RWAs for certain SFTs, but the PRA does not consider that this would materially impact finance for the real economy.

Unfunded credit protection

5.93 This section sets out the PRA's detailed proposals relating to the following aspects of the UFCP framework:

- eligibility criteria for recognising UFCP;
- application of UFCP methods, including the formulae to be applied; and
- other proposals relating to UFCP.

5.94 The proposed availability of the UFCP methods themselves is set out in the section 'Methods for recognising CRM' of this chapter.

Eligibility criteria for recognising UFCP

General principles for UFCP recognition

5.95 Currently, the eligibility criteria for UFCP generally depends on whether a firm uses either, (a) the SA or the FIRB approach, or (b) the AIRB approach. The PRA proposes to instead define eligibility criteria for UFCP that depend on the CRM method that is being used. This is because the PRA considers that it would be appropriate for all firms to be subject to the same UFCP eligibility criteria when they employ a given UFCP methodology.

Conditional and unconditional guarantees

5.96 UFCP can currently only be recognised if it is considered 'unconditional' (ie it does not contain any clause outside the direct control of the lender that would make the credit protection ineffective), with the exception that firms using the AIRB approach can recognise conditional guarantees with PRA permission.

5.97 Under the Basel 3.1 standards, firms can no longer recognise conditional guarantees as CRM under the AIRB approach. The BCBS decided to remove recognition of conditional guarantees because it considered that firms were unable to model the risk-mitigating effect of such guarantees in a robust manner. The PRA shares these concerns, and therefore proposes that recognition of conditional guarantees would not be permitted under all CRM methods.

5.98 Firms can currently recognise a range of credit derivatives as CRM, including basket credit derivatives such as '1st to default' credit derivatives and '2nd to default' credit derivatives. The ability to recognise basket credit derivatives as CRM is not included in the

Basel 3.1 standards with the exception of ‘1st to default’ credit derivatives, which may be recognised by firms using the AIRB approach only. These restrictions on recognition reflect the BCBS and PRA’s concerns regarding the challenges firms have had in accurately including the risk-mitigating effect of basket credit derivatives in non-modelled approaches and in robustly modelling ‘2nd to default’ and higher-order basket credit derivatives.

5.99 The PRA proposes to prohibit firms from recognising basket credit derivatives in the CRM framework with the exception of ‘1st to default’ credit derivatives, which firms would only be able to recognise where they are using the ‘LGD adjustment method’. This would align with the Basel 3.1 standards by allowing firms to recognise ‘1st to default’ credit derivatives only where they are applying a modelled CRM approach.

5.100 Currently, UFCP can generally only be recognised where it is direct. However, firms can exceptionally recognise indirect credit protection where a counter-guarantee provided by a sovereign or quasi-sovereign is in place.

5.101 The Basel 3.1 standards restrict the eligibility of indirect counter-guarantees to those provided by sovereign entities only. The PRA considers that, in general, indirect credit protection arrangements such as counter-guarantees are less likely to be effective than direct credit protection arrangements, and that this risk is greater for such arrangements when provided by non-central government and non-central bank counter-guarantors compared to central government and central bank counter-guarantors. The PRA therefore proposes to restrict the eligibility of indirect counter-guarantees to those provided by central governments and central banks only. However, the PRA proposes that firms would still be able to treat counter-guarantees provided by other guarantors as eligible where they are further guaranteed by a central government or a central bank.

5.102 In general, firms are only able to recognise guarantees in the CRM framework where they have the right to pursue the guarantor in a timely manner for monies due under the guarantee agreement. The CRR does, however, allow firms to apply alternative criteria for guarantees provided in the context of mutual guarantees schemes, or when provided by, or counter-guaranteed by, an entity that can provide eligible counter-guarantees. The effect of these alternative criteria is that such guarantees may be eligible where a provisional payment has been made under the guarantee, or the firm can demonstrate to the PRA that the effect of the guarantee makes an alternative treatment appropriate.

5.103 The PRA proposes to continue to align the eligibility criteria for recognising such guarantees with the list of entities eligible to provide counter-guarantees. As a result, the alternative criteria would only be available for guarantees provided in the context of mutual guarantee schemes, and guarantees that are either provided by, or counter-guaranteed by, a central government or central bank. The PRA considers that this is appropriate to reflect the prudential risk relating to non-timely payment of guarantees by entities other than central governments and central banks.

5.104 The PRA also proposes to make the following minor changes to the criteria for recognising UFCP:

- to introduce an explicit requirement that UFCP would only be eligible if it does not contain any clause which would allow the protection provider to change the credit protection unilaterally to the detriment of the lender. The PRA does not consider this would be a significant change to existing requirements;
- to clarify in the eligibility criteria for guarantees that it would be permissible for the guarantor to either make a lump sum payment or assume the future obligations of the counterparty in the event of a valid claim on the guarantee; and
- to clarify in its expectations that credit insurance (including mortgage indemnity products) can be treated as eligible UFCP where the eligibility criteria are met, and that such credit insurance would be treated as a guarantee or a credit derivative depending on whether the credit insurance effectively functions like a guarantee or a credit derivative respectively.

Application of UFCP Methods

Risk weight substitution method: revised formula

5.105 The PRA proposes to introduce a revised formula for calculating risk weights for firms using the risk weight substitution method. Under the revised formula, firms would calculate risk weights as a weighted average of:

a) the risk weight that would apply in the absence of credit protection for any part of the exposure not covered by UFCP (calculated using the SA or the IRB approach, as appropriate); and

b) the risk weight that would apply to a comparable direct exposure to the protection provider under the SA for the part of the exposure covered by UFCP.

5.106 The PRA also proposes to introduce a formula for calculating the expected loss (EL) when applying the IRB approach and using the risk weight substitution method. Under the revised formula, firms would calculate risk weights as a weighted average of:

a) the EL that would apply in the absence of credit protection for any part of the exposure not covered by UFCP; and

b) specific provisions relating to the part of the exposure covered by UFCP.

5.107 The PRA's proposed EL formula is designed to ensure that the amount of EL calculated aligns with specific provisions for the guaranteed part of the exposure and that these net-off in the 'expected loss – provisions' ('EL – P') calculation used to calculate capital resources for firms applying the IRB approach (see Chapter 4). The PRA considers that this calculation would best align risk weights calculated under the risk weight substitution method across the SA and the IRB approach.

5.108 The PRA considers that the revised risk weight and EL formula would provide greater clarity as to how firms should calculate risk weights and ELs when using the risk weight substitution method and applying the IRB approach.

Parameter substitution method: revised formula

5.109 The PRA proposes to introduce a revised formula for calculating risk weights for firms using the parameter substitution method. Under the revised formula, firms would calculate risk weights as a weighted average of:

a) the risk weight that would apply in the absence of credit protection for any part of the exposure not covered by UFCP; and

b) a revised risk weight calculated using the PD and risk weight function of the protection provider, and either the LGD applicable to the exposure (as if there was no UFCP) or the FIRB approach LGD applicable to the protection provider, for the part of the exposure covered by UFCP.

5.110 The PRA also proposes to introduce an analogous formula for the calculation of EL under the parameter substitution method. The PRA considers that the revised risk weight and EL formulae would provide greater clarity as to how firms should calculate risk weights and ELs under the parameter substitution method.

5.111 Firms applying the parameter substitution method and substituting the PD of the exposure with the PD of the protection provider currently apply the IRB risk weight formula that is applicable to the exposure in accordance with the CRR. This is a different approach to that in the Basel 3.1 standards, where the IRB risk weight formula relevant to the protection provider is instead applied for the protected part of the exposure.

5.112 The PRA considers that the approach set out in the Basel 3.1 standards is more logical because the purpose of PD substitution is to replace the risk of obligor default with the risk of guarantor default, and the Basel 3.1 standards reflect this in full. In contrast, the PRA considers the existing CRR approach is somewhat inconsistent because it combines the risk weight function formula of the exposure with the PD of the guarantor.

5.113 The PRA therefore proposes that firms using the parameter substitution method would apply the IRB risk weight formula relevant to the protection provider for the protected part of the exposure.

Parameter substitution method: LGD for the part of an exposure covered by UFCP

5.114 Firms using the parameter substitution method can choose to substitute the LGD associated with the guarantee as well as substituting the PD. As set out in the 'Methods for recognising CRM' section of this chapter, firms would be able to choose to use the parameter substitution method where the exposure is subject to the AIRB approach and a comparable direct exposure to the guarantor would also be subject to the AIRB approach. The PRA therefore considers it necessary to clarify whether the LGD of the comparable direct exposure to the guarantor which firms may substitute for the LGD of the exposure should be calculated under the FIRB approach or the AIRB approach.

5.115 The PRA proposes to clarify that the LGD of the comparable direct exposure to the guarantor would be calculated under the FIRB approach. The PRA considers that this would be more appropriate, given that the parameter substitution method is intended to be a non-modelled CRM technique, and because it considers that substitution of modelled LGDs under this method could result in insufficiently robust outcomes. The PRA recognises that a consequence of this proposal is that firms using the parameter substitution method would not be able to substitute LGDs for retail guarantors; however, the PRA does not expect that this would have a material impact.

LGD adjustment method: combining with adjustments to obligor grades

5.116 The PRA considers that there is some ambiguity in both the CRR and the Basel 3.1 standards regarding whether firms can combine the LGD adjustment method with adjustments to obligor grades (see Chapter 4).

5.117 The PRA considers that it is challenging for firms to simultaneously apply the LGD adjustment method and to reflect the impact of a guarantee through adjustments to obligor grades without double counting. The PRA therefore proposes to clarify that where firms recognise guarantees using the LGD adjustment method, they would not also be able to reflect the effect of the guarantee by adjusting obligor grades (see Chapter 4).

Other proposals relating to UFCP

Risk weight substitution of sovereign guarantees

5.118 Firms using the risk weight substitution method are currently able to apply a preferential sovereign risk weight treatment to exposures guaranteed or part-guaranteed by a central government or central bank, where the guarantee is denominated in the domestic currency of the obligor and the exposure is funded in that currency. The PRA proposes to change the criteria for applying preferential risk weights by introducing a requirement that the guarantee must be denominated in the domestic currency of the central government or central bank providing the guarantee, rather than in that of the obligor.

5.119 The PRA proposes this change because it considers that it would better reflect the purpose of the concessionary risk weight treatment and because the proposed change would align with the Basel 3.1 standards.

Credit derivative eligibility

5.120 The PRA proposes to extend certain existing expectations relating to guarantee eligibility to cover credit derivative eligibility, where the expectation in question relates to a requirement that applies equally to guarantees and credit derivatives. The PRA considers that this change would enhance the consistency and coherence of the regulatory framework (see Appendix 15).

Residual risks

5.121 The PRA proposes to withdraw an existing expectation that firms should consider residual risks arising from UFCP through adjustments to PDs, and instead proposes to set an expectation that these should be reflected in Pillar 2. The PRA considers that this change is necessary in order to align its expectations on residual risks with its proposed changes to CRM methods that are set out in this chapter.

Maturity mismatch treatment

5.122 As noted in the 'Funded credit protection' section, the PRA proposes to make a small number of minor changes to the approach for reflecting maturity mismatches in the CRM framework that are applicable to UFCP and FCP.

Question 37: Do you have any comments on the PRA's proposals for UFCP?

PRA objectives analysis

5.123 The PRA considers that the proposals set out in this section would advance its primary objective of safety and soundness. The proposals to prohibit recognition of conditional guarantees and restrict recognition of basket credit derivatives should improve firm safety and soundness given BCBS findings that such UFCP has not consistently had the desired risk-mitigating effect. The PRA considers that its proposals relating to the application of UFCP methods would advance its safety and soundness objective through better reflection of UFCP in RWAs, including that risk-mitigating effect of UFCP should not be double counted.

5.124 The PRA considers that the proposed restrictions on UFCP eligibility, including the proposals to remove the recognition of conditional guarantees, restrict recognition of basket credit derivatives, and restrict the eligible providers of counter-guarantees, would result in

RWA increases for firms currently reflecting these types of UFCP in their risk weights. The PRA considers that the proposals set out in this section would collectively represent a tightening of requirements for impacted firms because they would limit the circumstances in which firms would be permitted to recognise UFCP. The PRA considers that any increase in RWAs would be justified, as set out above.

5.125 The PRA considers the proposals set out in this section would advance its secondary objective to facilitate effective competition by simplifying the framework and addressing existing deficiencies in IRB modelling. The PRA considers the proposals would enable firms using the SA to compete more effectively with firms using the IRB approach, to the extent that addressing deficiencies in IRB modelling results in increased IRB RWAs.

'Have regards' analysis

5.126 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Relevant international standards (FSMA CRR rules):

- The PRA considers that the proposals set out in this section are broadly aligned with the Basel 3.1 standards. The PRA considers that some aspects of the Basel 3.1 standards are open to interpretation and has therefore made proposals that it considers implement the Basel 3.1 standards in line with its statutory objectives and 'have regards'.

2. Competitiveness (HMT recommendation letter) and relative standing of the UK as a place to operate (FSMA CRR rules):

- The PRA considers that the proposals in this section would be unlikely to materially impact UK competitiveness. The PRA considers that its proposals relating to UFCP eligibility are aligned with those that are expected to be adopted by other jurisdictions, but considers that there is some uncertainty as to how its other proposals relating to UFCP would compare to the approaches taken by other jurisdictions. The PRA considers that the overall impact of any such variations is uncertain, as they would potentially lead to higher RWAs relative to other jurisdictions for some exposures, while leading to lower RWAs for others. Overall, the PRA considers the impact on firms to be broadly neutral, with a range of uncertainty around that, and therefore invites firms to provide responses on the overall impact of the PRA's proposals.

3. Sustainable growth (FSMA regulatory principles) and sustainable real economy financing (FSMA CRR rules):

- The PRA does not expect that the proposals in this section would have a significant impact on sustainable growth. The PRA considers, however, that some of the proposals may increase RWAs for certain exposures (eg where currently eligible UFCP would be treated as ineligible), and that this may have an impact on firms' willingness undertake particular types of lending. The PRA considers, however, that its proposals would support sustainable growth by improving the robustness and clarity of the CRM framework.

4. Proportionality (FSMA regulatory principles and Legislative and Regulatory Reform Act 2006):

- The PRA considers that the proposals set out in this section would be a proportionate response to deficiencies in IRB modelling that have been identified by the BCBS and the PRA. The PRA considers that its proposals would result in a more risk-sensitive framework that would better align RWAs with risks.
- The PRA recognises that the proposal that firms using the parameter substitution method would apply the IRB risk weight formula relevant to the protection provider for the protected part of the exposure may slightly increase the operational burden on firms. This is because they would need to start calculating maturity (M) for retail exposures where they recognise UFCP provided by non-retail guarantors. The PRA considers, however, that its proposal is proportionate given that it considers that it would result in a more robust and coherent regulatory framework.

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1. Throughout this document and the PRA's proposals, 'SFT' means a repurchase transaction, a securities or commodities lending or borrowing transaction, or a margin lending transaction.
2. The Counterparty credit risk chapter of the CRR and the Counterparty Credit Risk (CRR) Part of the PRA Rulebook.
3. A 'comparable direct exposure to the protection provider' means a direct exposure to the protection provider of the same type and with the same characteristics as the exposure to the obligor in the absence of any UFCP.
4. **Reducing variation in credit risk-weighted assets - constraints on the use of internal model approaches**.
5. 'Principle 4: The standardised approach should not rely on internal modelled approaches to set capital charges. The capital charge should be based on easily verifiable and objective variables set by regulators. The process should not require supervisory approval.' (BCBS **'Revisions to the Standardised Approach for credit risk Consultative Document'**, March 2015).
6. See Chapter 2 – Scope and levels of application, which also describes the position for PRA-designated financial holding companies or mixed financial holding companies related to those UK banks and building societies.
7. The PRA expects all permissions granted under CRR Articles 199(6), 221(1) and 221(2) to be saved by HMT for firms implementing the Basel 3.1 standards. This would result in permissions granted under CRR Articles 199(6), 221(1) and 221(2) being deemed to be permissions under Articles 199(6), 221(1) and 221(2) of the Credit Risk Mitigation (CCR)

Part. For TCR firms see paragraph 2.26 of Chapter 2.

8. This is also currently referred to as 'Repo VaR' in PRA Supervisory Statement 12/13 '**Counterparty credit risk**', April 2013.

9. Volatility adjustments are applied to the market value of collateral to take account of price volatility when valuing collateral under the FCCM.

10. The FCCM formulae also include foreign exchange volatility adjustments, which the PRA does not propose to change.

11. The credit quality steps relate to external credit ratings as referred to in Chapter 3 – Credit risk – Standardised approach.

12. The liquidation period is the period of time over which exposure or collateral values are assumed to move before the firm can close out the transaction.

13. The proposed changes would also impact the SA-CCR approach.

14. Firms using the SA are currently subject to these validation requirements; however, the PRA proposes that these requirements would only be applicable to firms using the FIRB approach as it is proposed that firms applying the SA would use origination loan to value to calculate RWAs. Firms using the AIRB approach may also be affected due to the requirement to establish valuation standards that are generally consistent with the FIRB approach where collateral is recognised in LGD estimates.

15. See Appendix 15 and the Credit Risk Mitigation (CRR) Part for further details.

16. The proposed changes to the mapping relate to exposures to unrated corporates where the PRA proposes new risk weights of 65% and 135% and to exposures to institutions that qualify for credit quality step 1, where the PRA proposes a new risk weight of 30%. While exposures to providers of life assurance would not generally be treated as exposures to institutions under the Standardised approach chapter of the CRR and the Credit Risk: Standardised Approach (CCR) Part of the PRA Rulebook, the PRA proposes to update the OFCP method mapping to reflect the possibility of this new risk weight being assigned for completeness.

Appendices

- Appendix 4: Draft PRA Rulebook (CRR) Instrument [2023] (PDF 4.1MB)
- CP16/22 - Appendix 15: Draft amendments to Supervisory Statement SS17/13 'Credit Risk Mitigation' (PDF 1.5MB)
- Appendix 17: Draft amendments to Supervisory Statement SS12/13 – Counterparty credit risk (PDF 1.5MB)

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CP16/22 – Implementation of the Basel 3.1 standards: Market risk

Chapter 6 of CP16/22

Published on 30 November 2022

Content

Overview

6.1 This chapter sets out the Prudential Regulation Authority's (PRA) proposals to implement the Basel 3.1 standards on market risk. These comprise: new requirements for determining which positions should be allocated to the trading book; a recalibrated version of the existing standardised approach as a simplified standardised approach (SSA); and two new calculation methodologies – a new advanced standardised approach (ASA); and a new internal model approach (IMA). The new market risk framework and methodologies are proposed to replace the existing calculation methodologies for market risk capital requirements. Table 1 summarises how the key proposals map to the existing market risk framework.

Table 1: Summary of how the key proposals map to the existing market risk framework

Current framework	New framework (PRA proposals)	Location
Scope of application	New requirements on scope of application (Basel 3.1)	Scope of application (paragraphs 6.7–6.19)
Eligibility criteria for derogation for small trading book business Permission required to use IMA	Eligibility criteria for: • Derogation for small trading book business (unchanged) • SSA Desk-based permission to use IMA (Basel 3.1)	Eligibility for different approaches (paragraphs 6.20–6.29)
Standardised approach (Basel 2)	SSA (Basel 3.1)	Simplified standardised approach (paragraphs 6.30–6.38)
	ASA (Basel 3.1)	Advanced standardised approach (paragraphs 6.39–6.61)
IMA (Basel 2.5)	IMA (Basel 3.1)	Internal model approach (paragraphs 6.62–6.96)

6.2 The proposals in this chapter would:

- amend the existing Trading Book (CRR) Part of the PRA Rulebook;
- introduce a new Market Risk: Simplified Standardised Approach (CRR) Part of the PRA Rulebook;
- introduce a new Market Risk: General Provisions (CRR) Part of the PRA Rulebook;
- introduce a new Market Risk: Advanced Standardised Approach (CRR) Part of the PRA Rulebook;
- delete the existing Market Risk Part of the PRA Rulebook, transferring paragraphs 3 and 4 of that Part to Market Risk: Simplified Standardised Approach (CRR) and Market Risk: General Provisions (CRR) respectively; and
- amend Supervisory Statement (SS) 13/13 'Market risk'.

6.3 The PRA's proposals would implement the new market risk framework finalised by the Basel Committee on Banking Supervision (BCBS) in 2019. That framework was designed in response to the global financial crisis, which revealed material weaknesses in the Basel 2 market risk framework. Market risk capital requirements proved insufficient to absorb losses. As an immediate response, BCBS introduced a set of revisions to the market risk framework in July 2009, which we refer to as 'Basel 2.5'. The Basel 2.5 amendments were a necessary short-term fix, but they made the framework significantly more complex, and did not address all of the issues revealed by the crisis. The Basel 3.1 standards introduce a comprehensive set of amendments to the market risk framework. The PRA played a key role in designing and agreeing the new market risk standards.

6.4 The proposals in this chapter are intended to improve the coherence of the framework, promote consistency across firms, and more comprehensively address the market risks posed by firms' exposures. The proposals include a range of approaches of differing levels of sophistication to support proportionality. The proposals would:

- more clearly define the scope of the framework by introducing a stricter delineation between positions that should be allocated to the trading book and non-trading book, and specifying the treatment of internal hedges between the two books;
- retain a recalibrated version of the existing standardised approach as the SSA for firms with limited derivatives business. The updated calibration reflects market developments since the approach was initially introduced;
- introduce a new, more comprehensive standardised approach – the ASA. The PRA proposes that this would be used by firms that do not meet the criteria to use the SSA and that have not been granted supervisory permission to use the new IMA; and
- introduce a new IMA for firms that have been granted supervisory permission. This approach would replace the existing modelled approach.

6.5 The PRA proposes to add detail and apply targeted adjustments relative to the Basel 3.1 standards in several areas, described in more detail in the individual proposals below.[1] The most material areas are as follows:

- In the SSA:
  - introduce eligibility criteria that firms would need to meet to continue using the SSA;
  - amend SS13/13 to update the PRA's expectations on the calculation of modified duration as an input to the SSA; and
  - incorporate the substantive elements of existing technical standards relating to the existing market risk standardised approach into PRA rules.[2]
- In the ASA:
  - clarify the calculation of gross jump-to-default for the default risk charge (DRC);
  - adjust the treatment of exposures to carbon emissions trading schemes; and
  - expand the range of allowable data sources to determine risk weights for positions in collective investment undertakings (CIUs).
- In the new IMA:
  - add detail on the calculation of capital requirements for non-modellable risk factors (NMRFs) and requirements for recognition of NMRFs in back-testing;
  - simplify modelling approaches for positions in CIUs, subject to tests to ensure they are appropriately conservative;
  - clarify the treatment of non-trading book foreign exchange (FX) and commodity positions; and
  - update SS13/13 to revise the PRA's existing 'risks not in value-at-risk' (RNIV) framework, remove duplicative data standards, and remove requirements related to calculation methodologies made redundant by these proposals.

6.6 The proposals in this chapter are relevant to PRA-authorised banks, building societies, PRA-designated investment firms, and PRA-approved or PRA-designated financial holding companies or mixed financial holding companies ('firms'). The proposals would not apply to UK banks and building societies that meet the Simpler-regime criteria and choose to be subject to the Transitional Capital Regime proposals.[3]

Scope of application

6.7 The Basel 3.1 standards introduce new requirements on the scope of application of the market risk framework in three key areas:

- the assignment of positions to the trading book or non-trading book (which determines whether a position is subject to the market risk or credit risk framework respectively);
- the treatment of internal hedges (ie the requirements for when a firm can internally transfer risks between the market, credit, and credit valuation adjustment (CVA) risk frameworks); and
- requirements for exemptions from market risk capital requirements for positions used to mitigate structural foreign exchange (SFX) risk.

Assignment of positions to the trading book or non-trading book

6.8 The assignment of positions to the trading book or non-trading book determines whether they are treated under the market risk or credit risk framework. Aligned with the Basel 3.1 standards, the PRA proposes to:

- prescribe lists of positions that would need to initially be assigned to either the trading book or the non-trading book, and require that firms obtain PRA permission to deviate from those lists. Positions assigned to the trading book would be subject to market risk capital requirements;
- set restrictions on any subsequent reassignment of positions between the trading and non-trading books, and require that, except in specific circumstances, firms cannot reassign a position between trading and non-trading book more than once;
- require that when a position is reassigned between the trading and non-trading book, firms hold a capital add-on equal to any capital reduction resulting from the reassignment until the position matures or expires; and
- retain the requirement that market risk capital requirements must be calculated for all FX and commodity positions, whether allocated to the trading book or non-trading book.

6.9 The PRA considers that introducing objective criteria for assigning positions to the trading book or non-trading book would support a more consistent treatment of similar risks across firms. The proposals would also help to ensure that positions moving between the trading book and non-trading book continue to have appropriate capital requirements.

Treatment of internal hedges

6.10 Firms use internal hedges to manage risks that cross the trading book, non-trading book, and CVA portfolio. For example, to hedge a non-trading book position, a firm may enter into an interest rate derivative that is allocated to the trading book and then use an internal hedge to transfer the risk of that derivative from the trading book to the non-trading book. Aligned with the Basel 3.1 standards, the PRA proposes constraints on the recognition of internal hedges between risks in the trading book and non-trading book. Internal hedges would only be recognised where:

- for credit risk or counterparty credit risk hedges, the internal hedge would be recognised as unfunded credit protection in the credit risk mitigation framework (see Chapter 5 – Credit risk mitigation), and is exactly matched by a set of trading book positions with external third parties;
- for equity risk hedges, the internal hedge would be recognised as a hedge in the credit risk framework, and is exactly matched by a set of trading book positions with external third parties; and
- for general interest rate risk hedges, the hedges are conducted between the non-trading book and a dedicated internal hedge portfolio in the trading book that:
  - is separately capitalised from the rest of the trading book; and
  - only contains instruments that either directly arise from transactions with an external third party, or are exactly matched by a set of trading book positions with external third parties.

6.11 The PRA proposes that internal hedges between the trading book and the CVA portfolio would only be recognised where:

- the hedges would be recognised as eligible hedges in the CVA risk framework; and
- if the internal hedge is subject to curvature risk, default risk, or the residual risk add-on in the ASA, the internal hedge is exactly matched by a set of trading book positions with external third parties.

6.12 The PRA considers that these proposals would help to ensure that risks transferred between the trading book and non-trading book (or between the trading book and CVA portfolio) through internal hedges are either mitigated or have adequate capital requirements.

Exemptions from market risk capital requirements for positions used to mitigate structural foreign exchange risk

6.13 SFX risk is a risk that firms are exposed to when they have assets and capital resources that are denominated in a currency that is different to their reporting currency. In those situations, they are exposed to the risk of capital ratio volatility that is purely due to FX rate movements. Firms can mitigate SFX risk by holding unhedged FX positions such that the change in the value of foreign currency risk-weighted assets (RWAs) due to a movement in the FX rate is offset by a proportionate change in the value of the positions. Without exemptions for these FX positions, they would be subject to market risk requirements even though they are used to reduce capital ratio volatility.

6.14 The PRA proposes to supplement the existing requirements for SFX exemptions with two additional requirements, aligned with changes made in the Basel 3.1 standards:

- the size of the exempt position should not be greater than the size of position that neutralises a firm's capital ratio sensitivity; and
- the exempted positions should be exempted for at least six months.

6.15 The PRA considers that the additional requirements would ensure exemptions are only applied to positions they are intended to cover (those which reduce volatility in the capital ratio). They also set a more objective requirement to demonstrate that positions are structural and not subject to frequent adjustment.

6.16 The PRA proposes that management and mitigation of SFX risk should not depend on the capital calculation methodology, and therefore the exemptions should be available to all firms. To clarify this and remove potential ambiguity in the current rules, the PRA proposes the requirements on exemptions for SFX positions are moved to Article 325a1(18) of the Market Risk: General Provisions (CRR) Part.

PRA objectives analysis

6.17 The PRA considers that the proposals set out in this section advance the PRA's primary objective of promoting safety and soundness of firms. The proposals originate from the Basel 3.1 standards, which the PRA expects other jurisdictions will also implement. The proposals are intended to ensure that positions with market risks are appropriately capitalised by assignment to the trading book, and reduce the risk that subsequent reassignment of positions or internal hedging of risks lead to inadequate capital requirements. The proposed additional requirements on SFX exemptions would advance safety and soundness by limiting the size of exempted positions to those that meet the purpose of the exemption.

6.18 These proposals support the PRA's secondary competition objective in that they would help to ensure a more consistent assignment of positions to the trading book and non-trading book across firms. The proposals would also facilitate more consistent recognition of internal hedges across firms.

'Have regards' analysis

6.19 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Proportionality (FSMA regulatory principles and Legislative and Regulatory Reform Act 2006):

- The PRA considers that the benefits from the proposed requirements on position assignment are proportionate to the burden imposed on firms. By setting more objective requirements, the assignment of positions to the trading book or non-trading book would be simplified. The PRA considers that clarifying the application of the existing SFX exemption framework, explicitly limiting the size and duration of positions exempted, would be consistent with the current intent and practice for SFX exemptions and therefore should not impose material additional burden on firms.

2. Relevant international standards (FSMA CRR rules):

- The PRA considers its proposals on the scope of application would be materially aligned with international standards.

3. The principle that the PRA should exercise its functions transparently (FSMA regulatory principles):

- The PRA considers that introducing clearer requirements on the scope of application would be a more transparent approach to firms compared to the current subjective nature of these requirements.

4. Efficient and economic use of PRA resources (FSMA regulatory principles):

- The PRA considers that proposing clearer requirements on position assignment and internal hedges would reduce the amount of supervisory resource needed to review firms' individual practices.

Eligibility for different approaches

6.20 Consistent with the Basel 3.1 standards, the PRA proposes to introduce three approaches: the updated SSA; the ASA; and the new IMA. The PRA also proposes to retain the existing 'derogation for small trading book business'. The PRA proposes to implement new eligibility requirements to use the different approaches, which would be included in Market Risk: General Provisions (CRR) Part.

6.21 The existing derogation for small trading book business permits firms to use the credit risk approach to measure market risk, where the size of their on- and off-balance sheet trading book business is less than 5% of total assets, and less than £44 million (without the PRA's approval or notification). The PRA proposes to retain this derogation without amendment.

6.22 The SSA is a recalibrated version of the existing market risk standardised approach intended, in the Basel 3.1 standards, to be available to firms with limited market risks. The PRA proposes that firms meeting either of the following criteria can elect to use the SSA (without the PRA's approval or notification, and subject to the restriction in paragraph 6.23 below):

- the firm's aggregate market risk assets and liabilities are less than £440 million and less than 10% of total assets;[4] or
- the firm is eligible to use the derogation for small trading book business.

6.23 Consistent with the Basel 3.1 standards, the PRA additionally proposes that firms with correlation trading portfolios (CTP securitisations) should be prohibited from using the SSA due to the complexity of correlation trading.

6.24 The ASA is a comprehensive standardised methodology, intended in the Basel 3.1 standards to be available to all firms. Aligned with those standards, the PRA proposes that firms can elect to use the ASA without the PRA's approval or notification.

6.25 Consistent with the Basel 3.1 standards, the PRA proposes that firms need to seek permission to use the IMA, with permissions granted at trading desk level.

6.26 The PRA proposes that firms should be allowed to use a combination of IMA and ASA to calculate market risk capital requirements. However, a firm that uses the SSA would need to do so for all market risk positions, and a firm that uses the small trading book derogation would need to do so for its entire trading book.

PRA objectives analysis

6.27 The PRA considers that retaining the existing small trading book derogation, and a recalibrated version of the existing standardised approach (the SSA), while introducing the new ASA and IMA, advances the PRA's primary objective of safety and soundness. The derogation and SSA would provide operationally simple but conservative approaches for firms with limited market risks. The ASA is a more risk-sensitive methodology, more suitable than SSA for measuring more complex trading risks, and therefore would be made available to all firms. Finally, the IMA would provide an appropriate level of risk-sensitivity for firms with material market risks while being subject to an additional safeguard of PRA scrutiny of models by means of the permissions process. The proposed framework would advance the PRA's primary objective by enhancing firms' capture of market risk in their capital requirements, according to the size and complexity of their financial market activities.

6.28 The PRA also considers that the proposals would support its secondary competition objective by providing greater comparability of outcomes between firms across different approaches. The ability to gain permission to use the IMA at trading desk level would also reduce barriers to smaller firms using the most risk-sensitive approach to calculating capital requirements.

‘Have regards’ analysis

6.29 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government’s economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA’s analysis of the proposals:

1. Relevant international standards (FSMA CRR rules):

- The PRA proposals would align with international standards.

2. Proportionality (FSMA regulatory principles and Legislative and Regulatory Reform Act 2006):

- The PRA considers that the proposal to implement the four different approaches, each with a different level of operational complexity and risk-sensitivity, would provide an appropriate range of alternatives that are proportionate to the levels of market risk faced by different firms.

3. Different business models (FSMA regulatory principles):

- The PRA considers that the proposal to implement four different approaches also provides a range of alternatives for firms, depending on their degree of market risk-related activities. In particular, the relatively simpler SSA and derogation for small trading book business would be available to larger firms with limited and simpler trading activities.

4. Efficient and economic use of PRA resources (FSMA regulatory principles):

- The PRA has taken into account efficient and economic use of its resources. The proposals would limit the use of resources by restricting approval processes to reviewing firms’ own models for use under the IMA, and setting objective thresholds for the use of the SSA.

Simplified standardised approach (SSA)

6.30 The PRA proposes, aligned with the Basel 3.1 standards, to retain the existing market risk standardised approach, recalibrated to reflect market conditions and events since it was first introduced, for firms with limited derivatives business (as defined in the section 'Eligibility for different approaches').

Recalibration of the current standardised approach to be used as the SSA

6.31 Consistent with the Basel 3.1 standards, the PRA proposes to recalibrate the existing standardised approach by applying the following multipliers to the capital requirements calculated under the existing approach for each risk class:

Table 2: SSA multipliers

Risk Class	Multiplier
Interest rate position risk	1.3
Equity position risk	3.5
Foreign exchange (FX) risk	1.2
Commodity risk	1.9

6.32 The PRA considers the proposed recalibration would ensure capital requirements are sufficiently conservative for the risks faced by firms, while limiting operational burden by maintaining the methodologies within the existing standardised approach.

Other amendments to the SSA

6.33 The PRA proposes to make a number of consequential amendments to improve the overall coherence of the SSA rules, including:

- incorporating the requirements contained in existing technical standards on non-delta risks[5] and on the definition of market[6] into PRA rules;
- updating SS13/13 to include the substance of the existing guidelines on modified duration;[7] and
- amending cross-references to other parts of the CRR that are being amended (particularly to the credit risk standardised approach).

6.34 As part of incorporating technical standards into PRA rules, the PRA proposes not to directly prescribe lists of:

- appropriately diversified stock indices that may be exempted from equity specific risk;[8] and
- closely correlated currencies, for which a lower risk weight may be applied.[9]

6.35 Instead, to improve the responsiveness of the rules to changes in the market and support the efficient use of supervisory resource, the PRA proposes to replace those lists with the current criteria used by the PRA to identify appropriately diversified stock indices or closely correlated currencies. Firms would be able to self-identify appropriately diversified stock indices and closely correlated currencies according to the same criteria currently applied by the PRA.

PRA objectives analysis

6.36 The PRA considers that retaining a recalibrated version of the existing standardised approach is consistent with its primary safety and soundness objective. Once recalibrated, the SSA would remain generally more conservative than the new ASA for firms with limited and less complex market risks, and the resulting capital requirements would better reflect the market risks observed since it was first implemented.

6.37 Retaining the SSA would support the PRA's secondary competition objective by providing a simple approach that could be used by smaller firms with limited and less complex market risks.

'Have regards' analysis

6.38 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Proportionality (FSMA regulatory principles and Legislative and Regulatory Reform Act 2006):

- The PRA considers that its proposal would be proportionate. Recalibrating the existing standardised approach using high-level multipliers rather than changing the methodology would avoid the operational burden of implementing a new approach on firms using it.

2. Different business models (FSMA regulatory principles):

- The PRA considers that retaining the SSA offers a simpler approach for firms with business models that inherently are not focused on trading activities.

3. Relevant international standards (FSMA CRR rules):

- Retaining the SSA and recalibrating it using high-level multipliers aligns with the Basel 3.1 standards.

Advanced standardised approach

6.39 The Basel 3.1 standards introduce a new standardised approach (the ASA). The market risk capital requirements calculated under the ASA are calculated as the sum of three separate capital requirements:

- the Sensitivities-based Method (SbM) capital requirement;
- the residual risk add-on (RRAO); and
- the default risk charge (DRC).

6.40 The PRA considers that the ASA methodology represents a significant improvement in the measure of market risk under the standardised approach. Therefore, the PRA proposes to implement the ASA as set out in this section. As outlined in the section 'Eligibility for different approaches', the approach would be available for all firms.

Sensitivities-based method (SbM) capital requirement

6.41 The SbM calculates capital requirements based on the sensitivity of the value of a firms' positions to a specified set of market risk factors. At a high level, the PRA proposes that the SbM capital requirement methodology is implemented consistently with the Basel 3.1 standards, and therefore calculated through a number of steps:

- positions would be allocated to one or more of seven risk classes according to types of risks firms are exposed to (eg general interest rate risk, equity risk);
- each risk class would have a predefined set of risk factors. Risk factors are market variables relevant to the risk class, such as specific interest rates or FX rates, the movements of which would affect the value of positions;
- firms would calculate the sensitivity of each position to movements in the value of each risk factor, and multiply them by a prescribed risk weight – equivalent to the potential movement of that risk factor in stressed market conditions. Risk weights are scaled to take into account the relative liquidity of different risk factors. The resulting risk-weighted

sensitivities can be considered to be the potential loss to the firm's positions from the movement in that risk factor in a stressed market; and

- the risk-weighted sensitivities would be aggregated using prescribed formulae and correlations to allow for diversification benefit.

6.42 To address the risk that correlations can fluctuate in periods of stress, the final aggregation step would be performed three times, assuming specified high, medium, and low correlations between risk factor movements. The above steps would be followed separately for each risk class and the risk class-level capital requirements would then be aggregated as a simple sum. The total SbM capital requirement would be the largest of the capital requirements calculated for the three correlation scenarios.

Residual risk add-on (RRAO)

6.43 The RRAO is intended to ensure capital requirements are adequate to address complex or exotic risks not considered in the SbM or DRC. Aligned with the Basel 3.1 standards, the PRA proposes that the RRAO is calculated as the sum of gross notional amounts of positions multiplied by 1% for those with exotic underlyings,[10] and by 0.1% for those with other residual risks.[11]

6.44 Consistent with the Basel 3.1 standards, the PRA proposes to set out a non-exhaustive list of positions that would be considered to have exotic underlyings or be exposed to other residual risks.

Default risk charge (DRC)

6.45 The Basel 3.1 standards' DRC is intended to set capital requirements for default risk from credit and equity positions. It is calibrated to a similar degree of conservatism as the credit risk framework, but recognises a greater degree of offsetting between long and short positions. The methodology involves calculating the 'gross jump-to-default' exposure arising from each credit and equity position, applying a default risk weight (based on credit rating), and calculating the overall capital requirement after recognising a degree of offsetting benefit between long and short positions.

6.46 To support a clear and consistent interpretation of the ASA DRC framework, the PRA proposes to introduce a minor adjustment to the Basel 3.1 standards by requiring firms to calculate the 'gross jump-to-default' of an instrument as the difference between:

- the current market value of an instrument position; and
- the market value of the instrument assuming an instantaneous default of the underlying credit or equity instrument with recovery equal to a percentage of the notional or face

value of the instrument. The percentage would be determined as 1 minus the loss given default (LGD), with LGD prescribed in the PRA rules as per the Basel 3.1 standards.

6.47 The PRA considers that its proposed calculation of 'gross jump-to-default' improves the clarity and consistency of the DRC calculation. The PRA expects that its alternative definition would only rarely lead to different outcomes relative to the Basel 3.1 standards.

Question 38: Do you have any comments on the PRA's proposed definition of 'gross jump-to-default' in the ASA default risk charge?

Treatment of carbon emissions trading schemes

6.48 The Basel 3.1 standards do not provide a separate treatment for carbon emissions certificates. The PRA considers that, at present, there is insufficient evidence to propose a separate treatment. However, it proposes to provide a framework so the treatment could be easily amended in the future as carbon markets evolve. The PRA proposes to keep the treatment of carbon trading under review as evidence accumulates. As such, the PRA proposes to:

- introduce a distinct commodities bucket for carbon emissions certificates with a distinct risk weight and tenor basis correlation parameter; and
- set the risk weight and correlation for carbon emissions certificates identical to the Basel 3.1 standards for other commodities (ie a 60% risk weight and 99% tenor basis correlation).

Question 39: Do you have any comments on the PRA's proposal for carbon emissions certificates? What additional information could be considered for the calibration of risk weights and correlations, particularly relating to any historical period of stress?

Treatment of collective investment undertakings (CIUs)

6.49 The Basel 3.1 standards set out three approaches to calculating capital requirements for CIUs in the ASA:

Look-through approach (LTA): Where a firm knows the exact holdings of a CIU, firms can treat the holdings of the CIU as if they were on the firm's own balance sheet.

Mandate-based approach (MBA): Where a firm knows the investment mandate of the CIU (but not the actual holdings), firms can calculate their exposure by assuming that the CIU invests in a portfolio consistent with its mandate that generates the maximum possible capital requirement. Because the actual holdings may differ substantially from the mandate, no hedging or diversification benefit can be recognised between the capital requirements calculated under the MBA and other market risk positions.

Fall-back approach (FBA): Where a firm does not have the information for the LTA or MBA, or chooses not to use them, they would need to use the FBA. This approach makes no assumptions about the holding of the fund, and therefore a conservative risk weight of 70% is applied to the firm's position. Given the lack of knowledge of the fund positions, no hedging or diversification benefit is permitted with other market risk positions.

6.50 The PRA proposes to implement the above three approaches. In the case of the MBA, firms would require permission to apply this approach.

6.51 Additionally, the PRA proposes to implement a fourth approach for the treatment of CIUs – an external party approach (EPA). Under the proposed EPA, where a firm has access to a risk weight for the CIU that is calculated by an external party, the firm may use that risk weight for their position in the CIU provided that:

- the external party knows the exact holdings of the CIU and calculates the risk weight each reporting period in accordance with the LTA;
- the external party's risk weight calculation is externally audited, and the firm verifies the appropriateness of the external party's risk weight calculation; and
- no hedging or diversification benefit is permitted between the position in the CIU and other market risk positions.

6.52 The PRA considers its proposal to implement the EPA would offer a proportionate approach that provides more risk-sensitive capital requirements than the MBA and FBA, while being less operationally burdensome for firms. It would also be at least as conservative as the LTA, and therefore ensure capital requirements are aligned with the risk of the CIU position.

> **Question 40: Do you have any comments on the PRA's proposals to include the EPA for the treatment of CIUs in the new ASA?**

Treatment of non-trading book foreign exchange (FX) and commodity positions

6.53 The PRA proposes to introduce new rules that clarify how non-trading book FX and commodity positions should be reflected in the ASA. The proposal would be aligned with the Basel 3.1 standards, but provide additional prescription.

6.54 For FX risk positions in the non-trading book, the PRA proposes that firms may elect to use either the accounting or, if calculated at least quarterly, the fair value of those positions for the purposes of calculating capital requirements under the ASA. Aligned with the Basel

3.1 standards, the PRA proposes that under either option, firms should update the FX component of non-trading book positions at least monthly.

6.55 For commodity positions in the non-trading book, the PRA proposes that firms should recalculate the fair value of their positions at least monthly, and use the last available fair value in calculating capital requirements under the ASA.

6.56 The PRA considers this additional prescription would ensure a consistent treatment of such risks across firms.

PRA objectives analysis

6.57 The PRA considers that the proposed ASA advances its primary safety and soundness objective. It would improve the risk-sensitivity of capital requirements relative to the existing standardised approach, and more accurately capture default risks, residual risks, and exotic risks. This would better align capital with risk for firms using the ASA.

6.58 Regarding the treatment of carbon emissions trading certificates, the PRA considers that there is insufficient evidence at present to justify a less conservative treatment relative to the Basel 3.1 standards, and therefore has not adjusted the calibration based on primary objective concerns. In particular, there is a lack of data on how such markets may behave in periods of significant stress.

6.59 Regarding the treatment of CIUs, the PRA considers that the proposed EPA advances its primary safety and soundness objective, since the risk weight is calculated consistently with the LTA, but hedging and diversification recognition are constrained, reflecting that firms may not know the actual holdings of the CIU.

6.60 The PRA considers that the ASA furthers its secondary competition objective by introducing a credible alternative to internal models that would be accessible to firms with smaller trading portfolios. The improved risk capture and sensitivity of the ASA would mean that capital requirements are more commensurate with the actual risks faced by such firms.

‘Have regards’ analysis

6.61 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government’s economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA’s analysis of the proposals:

1. Proportionality (FSMA regulatory principles and Legislative and Regulatory Reform Act 2006):

- The PRA considers its proposals would support proportionality by introducing a risk-sensitive alternative to the IMA. Regarding the calculation of gross jump-to-default, the proposal would limit the burden for firms implementing the approach by setting out a clearly defined approach to be applied to all positions. Regarding the treatment of CIUs, the EPA is designed to provide a more proportionate alternative to the MBA and FBA while being less operationally burdensome to implement compared to the LTA and MBA.

2. Relevant international standards (FSMA CRR rules):

- The PRA considers the proposals to be aligned with international standards. In areas where the proposals differ from the Basel 3.1 standards, the PRA considers its proposals to achieve equivalent outcomes. The proposal for calculating 'gross jump-to-default' for DRC is aligned to the Basel 3.1 standards because it leads to a generally equivalent calculation. The proposed treatment of carbon emissions trading schemes is aligned with the Basel 3.1 standards. The PRA considers that its proposal to introduce the EPA remains aligned with the Basel 3.1 standards as the EPA would lead to capital requirements that are at least as conservative as under the LTA.

3. 2050 net-zero target in the Climate Change Act 2008 (HMT recommendation letters / FSMA CRR rules):

- The PRA considers that its proposal on the treatment of climate emissions trading schemes is consistent with the government's commitment to achieve a net-zero economy by 2050. The PRA concludes that its proposal for a more granular treatment of emissions certificates is warranted (at the cost of marginally increasing the complexity of the ASA) to provide scope for future adjustments to risk weights or correlations if sufficient evidence were to emerge that it was required.

4. Competitiveness (HMT recommendation letters):

- The PRA considers that its proposal on the treatment of CIUs supports the competitiveness of the UK as an attractive domicile for internationally active financial institutions trading in CIUs. It would provide an additional approach that is aligned to the Basel 3.1 standards, while being operationally simpler than the approaches in the Basel 3.1 standards.

5. The principle that the PRA should exercise its functions transparently (FSMA regulatory principles):

- The PRA considers that its proposal for the treatment of non-trading book FX and commodities positions would improve the clarity of its rules, ensuring a consistent treatment of these risks is applied across firms.

Internal model approach (IMA)

6.62 The Basel 3.1 standards introduce a new market risk IMA to replace the existing framework. Under the new IMA, the market risk capital requirement would be the sum of three separate components:

- an expected shortfall (ES) calculation which incorporates the variable liquidity of different risk factors;
- a default risk charge (DRC); and
- a separate capital requirement for non-modellable risk factors (NMRFs).[12]

6.63 Use of the new IMA would be subject to permission, which would be granted at the level of firms' trading desks. The Basel 3.1 standards introduce related requirements for the structure and eligibility of trading desks to use internal models.

6.64 The PRA considers that the improvements incorporated in the new IMA, including the better capture of liquidity risk in the ES calculation, and a prescribed treatment of NMRFs, would provide a more comprehensive, coherent, and consistent approach to calculating market risk capital requirements compared to the existing IMA. Therefore, the PRA proposes to implement the new IMA and related requirements on firms' trading desk structure as set out in this section. As outlined in the section 'Eligibility for different approaches', the IMA would be available to firms who receive permission from the PRA, and would be granted at trading desk level, aligned with the Basel 3.1 standards. As previously indicated,[13] the PRA would expect firms to submit final pre-application materials for new IMA permissions at least 12 months in advance of the PRA's proposed Basel 3.1 implementation date (see Chapter 1 – Overview).

Requirements for the trading desk structure for IMA permissions

6.65 The Basel 3.1 standards set requirements on the trading desk structure that firms are required to have in place when applying for permission and to use the IMA. The requirements are intended to promote consistent approaches across firms while aligning trading desks with the operational structure of firms' trading businesses. The PRA considers the requirements are important to ensure consistency across firms, and to provide clarity on how firms should prepare to request IMA permission. Therefore, the PRA proposes to implement the Basel 3.1 standards in this area without amendment.

Internal model approach (IMA) calculation

Expected shortfall

6.66 The Basel 3.1 standards introduce a new ES model to calculate the risk of losses in firms' trading positions due to movements in market variables (referred to as risk factors). Whereas value-at-risk (VaR) and stressed value-at-risk (SVaR) – the two models used in the existing framework – set capital requirements using the estimated loss that will not be exceeded over a given time frame to a certain level of confidence, ES considers both the size and likelihood of losses that might occur above a defined confidence level. The ES model is calibrated to a historical period of stress.

6.67 The new ES model includes two further enhancements relative to the existing approach:

- it recognises that correlations between different risk areas behave unpredictably in periods of stress, so diversification between broad risk factor types (eg equity, commodity) is restricted; and
- it better captures risk factor illiquidity in periods of stress by prescribing a 'liquidity horizon' ranging from 10 to 120 days for each risk factor. The ES is calculated based on estimated risks over a 10-day horizon, and scaled up to the prescribed liquidity horizon to determine the final ES risk measure for each risk factor.

6.68 The PRA proposes to implement the ES model, aligned with the Basel 3.1 standards, including two tests on the accuracy and conservatism of a firm's ES model that would need to be passed in order for it to be used to calculate capital requirements. The PRA's proposals would require that for each trading desk, a firm's model would need to continually pass 'back-testing' and 'profit and loss attribution tests' (PLAT) for the desk to be treated under the IMA. The proposals also prescribe back-testing requirements at the overall trading book portfolio level, aligned with the Basel 3.1 standards:

- Back-testing is a test of model conservatism. It counts the number of times that actual losses exceed the estimate from the firm's model (a back-testing 'exception'). The proposals would require that when a trading desk model exceeds a specified number of back-testing exceptions over a 12-month period, it would no longer be permitted to be treated under the IMA.
- PLAT are tests of model accuracy. PLAT applies two statistical tests that compare the time series of daily profit and loss (P&L) calculated using the risk factors and pricing models in the ES model, to the actual daily P&L of the trading desk. Simplifications in the model will cause the two time series to differ – if the tests show the differences exceed specified thresholds, this indicates there are material simplifications in the model and the desk would no longer be permitted to be treated under the IMA. Aligned with the Basel 3.1 standards, the PRA proposes to delay the application of this test for the purposes of

calculating market risk capital requirements (but not for reporting on them) until one year after the proposed IMA rules are implemented.

Default risk charge

6.69 The DRC in the Basel 3.1 standards is intended to measure the jump-to-default risk of credit and equity positions in a firm's trading book. Relative to the existing framework's model for default risk, the DRC would reduce unwarranted variability in modelled capital requirements by removing consideration of migration risk – captured under the ES model in the new framework – and providing greater specification of input parameters. It also requires both credit and equity portfolios to be modelled, replacing the existing option for firms to not include equity positions.

6.70 The PRA considers the DRC would improve consistency in capital requirements across firms, and by removing modelling of migration risk it would reduce the potential for the model to overlap with risks included in the ES model. It therefore proposes to implement the DRC, aligned with the Basel 3.1 standards.

Non-modellable risk factor (NMRF) framework

6.71 The Basel 3.1 standards introduce a new NMRF framework. The framework recognises that trading desks with permission to use the IMA may be exposed to risk factors for which there is limited market data and therefore not well suited to being modelled. The NMRF framework is intended to ensure that those risks have adequate capital requirements. The PRA has existing expectations for firms to consider capital add-ons for these types of risks, and it considers that introducing a consistent framework in rules would enhance the approach and ensure greater consistency across firms. It therefore proposes to implement the NMRF framework in the IMA approach as set out in paragraphs 6.72 to 6.78.

Data quality standards for NMRFs

6.72 The PRA proposes, aligned with the Basel 3.1 standards, that risk factors would only be permitted to be included in firms' ES models if they have at least 24 observations in the preceding 12 months, with at least four observations in any 90-day period in those 12 months. The PRA also proposes to include a series of qualitative criteria that the risk factor would need to meet. Risk factors not meeting any of the criteria would be excluded from a firm's ES model and would be separately capitalised through the NMRF framework using the approach described in paragraphs 6.73 to 6.76.

Capital requirements for NMRFs

6.73 Consistent with the Basel 3.1 standards, the PRA proposes that each NMRF would need to be capitalised based on an individual stress scenario that is at least as conservative as a standalone ES calculation for that NMRF. NMRFs would then be aggregated assuming a 36% correlation assumption between different NMRFs to recognise a degree of diversification benefit.

6.74 The PRA proposes to further clarify the Basel 3.1 standards by requiring that firms develop and document methodologies to calculate the capital requirement for individual NMRFs. Firms would be required to ensure their methodologies are adequately conservative, with a high degree of confidence, and consider any potential limitations in their calculations, including limitations arising from sparse data, portfolio non-linearities, or reliance on proxies.

6.75 The PRA proposes that the stress period used to calculate NMRF capital requirements for each risk category would be the 12-month period that either:

- maximises the sum of NMRF capital requirements for all NMRFs in that risk category; or
- maximises the ES calculation for modellable risk factors in the same risk category, where a firm is able to demonstrate that applying the same stress period for NMRFs would not result in a materially different outcome to a period that maximises the NMRF capital requirement.

6.76 The proposals would also add detail to the requirements set out in the Basel 3.1 standards, to support consistent implementation. They prescribe a methodology for firms to determine a time series of 10-day risk factor returns for calculating NMRF capital requirements. Where a firm is unable to identify an appropriate individual stress scenario for an NMRF, the PRA proposes a fall-back approach where the firm would determine NMRF capital requirements by applying a shock to the NMRF that is:

- for positions with a finite maximum loss, the shock to the risk factor that would lead to that maximum loss; and
- for positions with an infinite maximum loss, the greater of:
  - a qualitatively-determined shock to the NMRF that would not be exceeded in a future stress period with 99.95% certainty; or
  - the shock that would lead to the maximum historically observed loss on that NMRF.

Recognition of NMRFs in back-testing

6.77 For the purposes of the proposed back-testing requirements for the IMA, the PRA proposes to specify how NMRFs should be treated. The Basel 3.1 standards require NMRFs to be excluded from models used for back-testing at both trading desk level and portfolio level. Recognising that under this approach back-testing exceptions could be due to NMRFs being excluded from the model rather than poor model performance, the Basel 3.1 standards contemplate supervisors permitting firms to ignore such exceptions where the capital requirements for a single NMRF are greater than the entire daily loss. The PRA proposes to implement a more risk-sensitive and flexible approach than the Basel 3.1 standards that it considers would ensure capital requirements are proportionate to the risk of firms using insufficiently conservative models. The proposal would require that:

- when performing back-testing at the trading desk level, firms may elect to include NMRFs in their model; and
- when performing back-testing at the overall trading book portfolio level, firms would need to exclude NMRFs from their model – firms would be permitted to ignore back-testing exceptions at portfolio level that are caused by NMRFs if approved by the PRA.

6.78 The proposals would require firms to report the NMRFs they elect to include in their model at trading desk level and to regularly report back-testing performance at the overall portfolio level.

Question 41: Do you have any comments on the PRA's proposals to recognise NMRFs in your model for the purposes of back-testing at the trading desk level? To what extent would you be able to incorporate NMRFs into your model for back-testing?

Treatment of collective investment undertakings

6.79 The Basel 3.1 standards prescribe that firms may only apply the IMA to positions in CIUs where the firm looks through to the CIU’s underlying positions and models them as though they are held on the firm’s balance sheet. The PRA considers that the ability to look through to the underlying holdings of a CIU is an important component of risk estimation. However, to reduce the operational burden on firms, the PRA proposes a simpler approach that it considers would achieve an outcome that is at least as conservative as the Basel 3.1 standards.

6.80 The PRA proposes to allow firms to apply the IMA to positions in CIUs, without separately modelling each underlying position, where:

- the firm is able to look through to the underlying positions of the CIU; and
- the firm, at a minimum annually, demonstrates to the PRA that the outcomes of its modelling of the CIU are consistent with or clearly more conservative than modelling by looking through to the underlying positions of the CIU.

Question 42: Do you have any comments on the PRA's proposal to allow firms a greater degree of modelling flexibility for CIUs in IMA?

Treatment of non-trading book FX and commodity positions

6.81 Similar to its proposals for the ASA, the PRA proposes to clarify how non-trading book FX and commodity positions should be reflected in the IMA. The proposals would be aligned with the Basel 3.1 standards, but provide additional prescription to ensure consistent and transparent treatment of these risks across firms.

6.82 To include non-trading book FX risk positions in their IMA calculations, the PRA proposes that firms should update the value of those positions to reflect changes in FX rates at least daily.

6.83 To include non-trading book commodity positions in their IMA calculations, the PRA proposes that firms should also update the fair value of those positions at least daily.

6.84 For the purposes of back-testing and PLAT, the PRA proposes to clarify that:

- for non-trading book FX positions that are not fair-valued and whose value moves linearly with respect to FX rates, firms would be required to include the effect of changes in FX rates in actual and hypothetical P&L calculations. Firms would be permitted to elect to include the effect of changes in all risk factors that determine the value of those positions; and
- for non-trading book commodity positions, consistent with the proposed requirement to fair-value non-trading book commodity positions for the IMA, firms would be required to include the full change in the fair value of such positions in actual and hypothetical P&L calculations.

Replacing the PRA's risks not in value-at-risk framework with a risks not in model framework

6.85 In addition to the proposed implementation of the IMA, the PRA proposes to introduce a rule that would require firms to hold additional capital requirements for material deficiencies in risk capture in their internal models. The PRA proposes to set out its expectations for meeting this requirement by amending its existing RNIV framework in SS13/13 and convert it into a new 'risks not in model' (RNIM) framework through amendments to:

- specify the scope of the RNIM framework to cover risks not included either in a firm's ES model or NMRF framework, and risks not included or adequately capitalised in firms' DRC models;
- be clear that firms are expected to identify all model limitations and missing risks. Firms would be expected to maintain a centralised inventory to track limitations and assumptions that may have an impact on the output of market risk models;
- specify that while all model limitations and missing risks should be identified, firms would only be required to hold RNIM capital add-ons for any material risks not adequately

captured by internal models;

- include an expectation that, where appropriate, firms should calculate RNIM capital add-ons in accordance with the PRA's proposed requirements on calculating capital requirements for individual NMRFs; and
- add a procedure whereby firms seek agreement from the PRA to recognise limited diversification or offsetting benefits between specific RNIMs where empirically justified.

6.86 Additionally, the PRA proposes that:

- subject to receiving an explicit waiver from the PRA, firms may be permitted to recognise the contributions of RNIMs in the PLAT test; and
- firms would be required to continue holding RNIM capital add-ons for at least 12-months for trading desks that have reverted to the ASA by reason of failing the desk-level back-testing or PLAT requirements.

6.87 The PRA considers that its proposed conversion of the RNIV framework into the RNIM framework would remove potential overlaps between RNIMs and NMRFs. This is specifically by clarifying that firms are required to hold RNIM capital add-ons only for material risks not adequately captured in internal models, and by potentially recognising some diversification or offsetting benefits across RNIMs. Similarly, the PRA considers that its proposal to have a process to potentially allow the contributions of RNIMs in PLAT removes potential overlap of requirements and would be proportionate and consistent with the prudential intention of the PLAT test as a test of model accuracy.

6.88 The PRA considers that its proposal to require firms to continue holding RNIM capital add-ons for trading desks failing back-testing or PLAT would ensure that capital requirements for desks failing back-testing or PLAT do not see an automatic reduction in capital requirements as a result of the removal of RNIM capital add-ons, which may not be adequately captured under the ASA.

Amendments to SS13/13 'Market risk'

6.89 As a consequence of implementing the new IMA, the PRA proposes to amend SS13/13 to delete previous guidance relating to the existing IMA that ceases to be relevant under the IMA.

6.90 The PRA also proposes to amend Chapter 12 of SS13/13 to update the existing expectation on 'Significant Influence Function (SIF) attestation' with a reference to the PRA's senior managers' framework.

PRA objectives analysis

6.91 The PRA considers that introducing the new IMA as outlined above advances its primary objective of safety and soundness. The proposals address significant shortcomings identified by the BCBS and PRA in the existing framework, by:

- implementing a new risk measure (ES) that more effectively considers tail risks relative to the existing model;
- constraining diversification benefits between broad risk factor types, to better recognise that correlations between very different risks behave unpredictably in periods of stress;
- recognising risk factor illiquidity in periods of stress by prescribing different 'liquidity horizon' to risk factors;
- reducing pro-cyclical IMA capital requirements, by removing the current VaR risk measure which is calibrated to the most recent 12-month period; and
- restricting the use of IMA where firms cannot demonstrate that they are reasonably able to model risks, via the NMRF framework and back-testing and PLAT requirements.

6.92 The proposals to implement the NMRF framework would ensure that firms take into account material data limitations and potential losses in stressed periods when calculating individual NMRF capital requirements. The PRA considers that requiring permission to exclude back-testing exceptions due to NMRFs at the portfolio level, and defining reporting requirements on NMRFs included in back-testing at trading desk level, advances its primary objective by providing safeguards around how firms are taking account of NMRFs in the back-testing process.

6.93 Regarding the treatment of CIUs, the PRA considers that its proposals would ensure modelling approaches reflect the risks of underlying holdings, while reducing the operational burden on firms.

6.94 The PRA considers that its proposed introduction of an RNIM framework to include DRC model deficiencies advances its primary safety and soundness objective by ensuring that all model deficiencies are subject to review, and if material, capital add-ons. The PRA considers that its proposal to require firms to continue holding RNIM capital add-ons for trading desks failing back-testing or PLAT would also advance its primary safety and soundness objective by ensuring that overall capital requirements for desks that fail back-testing or PLAT would not have an automatic reduction in capital requirements, where such risks may not be adequately captured under the ASA.

6.95 The proposals would support the PRA's secondary competition objective by restricting the use of IMA where modelling is not prudent, helping ensure that lower capital requirements for firms with modelling permission are only achieved where modelling is appropriate. By allowing model permission to be granted at trading desk level, the proposals would also reduce barriers to smaller firms being able to use the approach.

'Have regards' analysis

6.96 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Proportionality (FSMA regulatory principles and Legislative and Regulatory Reform Act 2006):

- The PRA considers that the proposals would provide a risk-sensitive approach for firms with substantial market risk, which would ensure the regulatory burden is commensurate with the risks that such firms are exposed to. The proposed additional prescription on identification of stressed periods would minimise the NMRF framework's operational burden, and the proposed approach to the treatment of NMRFs in back-testing would overcome potentially unduly conservative outcomes from the Basel 3.1 standards' approach. The burden that would arise from the PRA's proposed treatment of CIUs remains proportionate to its benefits by offering a degree of additional flexibility to firms modelling CIUs.

2. Relevant international standards (FSMA CRR rules):

- The PRA considers that the proposals are materially aligned with international standards. The proposed methodology for calculating capital requirements under the NMRF would clarify the approach in the international standards while retaining a similar level of conservatism. The proposed treatment of NMRFs in back-testing, while more flexible than international standards, aligns with the intent of international standards by ensuring that firms would not have to hold duplicative capital requirements for the same risks. Regarding the treatment of CIUs, the PRA considers that its proposal to allow firms to take an operationally less burdensome approach to modelling remains aligned with the outcome of the international Basel 3.1 standards.

3. Efficient and economic use of PRA resources (FSMA regulatory principles):

- The PRA considers the benefits of improved risk capture justify the supervisory resource required to review and approve firms' applications to use IMA, which include ensuring that the relevant modelling standards are met. Due to the relative importance of the NMRF framework, the PRA considers it an efficient use of supervisory resources to review the methodologies developed by firms.

- The PRA considers that its proposals to prescribe how firms identify stress periods and risk factor returns for NMRFs would remove the need for supervisors to review individual firms' methodologies, minimising the use of supervisory resources.
- The PRA's proposal to permit firms to incorporate NMRFs in models for back-testing at the trading desk-level would also limit the need for supervisory resource to review firm requests to ignore exceptions.
- In contrast, the PRA considers that requiring supervisory approval to exclude back-testing exceptions at the overall trading portfolio level provides important visibility and assurances around how firms are including NMRFs in their models, and the related supervisory resource would be limited, given the smaller number of calculations required for portfolio-level back-testing.

4. Competitiveness (HMT recommendation letters):

- The PRA considers that its proposals on the treatment of CIUs and of NMRFs in back-testing support the competitiveness of the UK as an attractive domicile for internationally active financial institutions. Allowing firms to include NMRFs in their back-testing models would potentially reduce exceptions that could arise from NMRFs (where they have been capitalised already). For CIUs, the proposals minimise the operational burden of modelling CIUs.

5. The principle that the PRA should exercise its functions transparently (FSMA regulatory principles):

- The PRA considers that its proposal for the treatment of non-trading book FX and commodities positions would provide improve clarity of its rules, ensuring a consistent treatment of such risks is applied across firms.

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1. The PRA expects all permissions granted under CRR Articles 325b(2), 352(2), 329(1), 352(1), 358(3), and 331(1) as at 31 December 2024, to be saved by HMT for firms implementing the Basel 3.1 standards. This would result in permissions granted under CRR Articles 325b(2) and 352(2) being deemed to be permissions under Articles 325b(2) and 325(9) of the Market Risk: General Provisions (CRR) Part, and permissions granted under CRR Articles 329(1), 352(1), 358(3), and 331(1) being deemed to be permissions under Articles 329(1), 352(1), 358(3) and 331(1) of the Market Risk: Simplified Standardised Approach (CRR) Part. For TCR firms, see paragraph 2.26 of Chapter 2.
2. Based on the PRA's understanding that HMT will revoke all existing technical standards relating to the existing market risk framework.
3. See Chapter 2, which also describes the position for PRA-designated financial holding companies or mixed financial holding companies related to those UK banks and building societies.
4. The PRA proposes that thresholds stated in EUR or USD in the Basel 3.1 standards are converted into GBP (see Chapter 13 – Currency redenomination).

5. **Commission Delegated Regulation (EU) No 528/2014** and **Commission Delegated Regulation (EU) 2016/861**.
6. **Commission Delegated Regulation (EU) No 525/2014**.
7. Currently set out in: **Guidelines on corrections to modified duration for debt instruments | European Banking Authority**.
8. Currently prescribed in: **Commission Implementing Regulation (EU) 2020/125.**
9. Currently prescribed in: **Commission Implementing Regulation (EU) 2019/2091**.
10. Defined as instruments where the underlying exposure is not within the scope of either SbM or DRC.
11. Defined as instruments that are either (a) subject to vega and curvature risk in SbM (ie non-linear instruments) and with pay-offs that cannot be written or perfectly replicated as a finite linear combination of vanilla options with a single underlying, or (b) instruments that fall under the definition of the correlation trading portfolio.
12. Risk factors with limited observable market data.
13. PRA Letter to firms **'Fundamental Review of the Trading Book (FRTB): Timetable for submission of internal model/standard approach pre-applications'**, June 2022.

Appendices

Appendix 4: Draft PRA Rulebook (CRR) Instrument [2023] (PDF 4.1MB)

Appendix 16: Draft amendments to Supervisory Statement SS13/13 – Market Risk (PDF 1.9MB)

Previous chapter Next chapter

CP16/22 – Implementation of the Basel 3.1 standards: Credit valuation adjustment and counterparty credit risk

Chapter 7 of CP16/22

Published on 30 November 2022

Content

Overview

7.1 This chapter sets out the Prudential Regulation Authority's (PRA) proposals to implement the Basel 3.1 standards on credit valuation adjustment (CVA) risk. These comprise the introduction of three new methodologies for calculating CVA capital requirements: the alternative approach (AA-CVA), the basic approach (BA-CVA), and the standardised approach (SA-CVA). The proposed CVA risk framework and methodologies would replace the existing calculation methodologies for CVA capital requirements.

7.2 The proposals in this chapter would:

- complement HM Treasury's (HMT) proposed revocation of certain Capital Requirements Regulation (CRR) articles and associated technical standards;
- delete the Credit Valuation Adjustment Risk (CRR) Part of the PRA Rulebook (Appendix 4);
- introduce a new Credit Valuation Adjustment Risk Part of the PRA Rulebook to replace the CRR requirements (Appendix 4);
- amend the Counterparty Credit Risk (CRR) Part of the PRA Rulebook (Appendix 4); and
- amend Supervisory Statement (SS) 12/13 – 'Counterparty credit risk' (Appendix 17).

7.3 In accordance with the Basel 3.1 standards, the PRA proposes to remove the use of internal models for CVA capital requirement calculations. Instead, the PRA proposes to introduce the Basel 3.1 standardised approach, which is based on sensitivities that would allow firms to include the effects of market risk factors on CVA risk. The PRA considers that the reduced reliance on models would promote consistency across firms in capturing CVA risk.

7.4 The proposals set out in this chapter would implement the new CVA risk framework finalised by the Basel Committee on Banking Supervision (BCBS) in 2019. The new framework is intended to improve the risk-sensitivity and comparability of CVA capital requirements, and incorporates the following improvements relative to the existing framework:

- a more comprehensive treatment of CVA risks and a better recognition of CVA hedges;
- closer alignment with industry CVA practices for accounting purposes;
- new methodologies, which have less reliance on modelling; and
- alignment with the new market risk framework methodology (set out in Chapter 6 – Market risk) in the case of the most advanced method (SA-CVA).

7.5 This chapter also sets out the PRA's proposals for the overall scope and calibration of capital requirements for derivative exposures, following a holistic review of the appropriateness of the aggregate capital requirements from the CVA risk and counterparty credit risk (CCR) frameworks. As a result of the review, and in addition to implementing the new CVA risk framework's methodologies, the PRA proposes to make the following changes to the scope and calibration of the CVA risk and CCR frameworks:

- increase the scope of application of the CVA risk framework, relative to the CRR, to include exposures to sovereigns, non-financial counterparties, and pension funds. Legacy trades would have transitional arrangements available;
- apply a targeted reduced risk weight in the CVA risk framework compared to the Basel 3.1 standards for exposures to pension funds; and
- apply a reduced 'alpha factor' of one in the standardised approach to counterparty credit risk (SA-CCR) framework for calculating exposures to non-financial counterparties and pension funds.

7.6 The PRA proposes to retain the existing CRR exemption for client clearing transactions. Regarding intragroup transactions, HMT has set out its intention to retain the existing exemption from CVA capital requirements, while creating flexibility in legislation for the PRA to create firm-specific rules. The PRA proposes to utilise this flexibility to introduce an additional approach for intragroup transactions to be exempted from CVA capital requirements, supplementing the existing approach under the CRR, based on a series of risk-based conditions.

7.7 The total amount of capital requirements for derivative exposures to counterparties is therefore a combination of the new methodologies and the increase in scope of application of the CVA risk framework, as well as the targeted reduced recalibrations across the CVA and SA-CCR frameworks. In considering the CVA risk and CCR frameworks together, the PRA considers the proposed package would result in a more coherent and consistent framework, assigning the appropriate amount of capital against relevant risks.

7.8 The proposals in this chapter are relevant to PRA-authorised banks, building societies, PRA-designated investment firms, and PRA-approved or PRA-designated financial holding companies or mixed financial holding companies ('firms'). The proposals would not apply to UK banks and building societies that meet the Simpler-regime criteria and choose to be subject to the Transitional Capital Regime proposals.[1]

Credit valuation adjustment risk framework

7.9 The PRA proposes to implement the CVA risk framework set out in the Basel 3.1 standards by introducing a new Credit Valuation Adjustment Part of the PRA Rulebook, which would introduce new rules that:

- define the scope of application for transactions to be included in CVA capital requirements (section 'Scope of application');
- introduce a notifications process for firms intending to use the alternative approach, and a permissions process for firms wishing to use the standardised approach (section 'Eligibility for different approaches');
- implement the following methodologies:
  - the alternative approach (AA-CVA) for firms with limited non-centrally cleared derivatives (see 'The alternative approach (AA-CVA)' section in this chapter);
  - the basic approach (BA-CVA) that can be used by all firms (see 'The basic approach (BA-CVA)' section in this chapter); and
  - the standardised approach (SA-CVA) that can be used by firms that have been granted supervisory approval (see 'The standardised approach (SA-CVA)' section in this chapter).

Scope of application

7.10 Consistent with the Basel 3.1 standards, the PRA proposes that CVA capital requirements would need to be calculated by all firms undertaking covered transactions in both the non-trading book and trading book. Covered transactions include:

- over-the-counter (OTC) derivatives that are not cleared with a qualifying central counterparty, or that are not client clearing transactions;[2] and
- securities financing transactions (SFTs) that are fair-valued by a firm for accounting purposes and where CVA risk arising from these transactions is material, in accordance with PRA Supervisory Statement 12/13 – **'Counterparty credit risk'**.

7.11 Following the PRA's holistic review of the calibration of capital requirements for derivative exposures, the proposed implementation would no longer exempt transactions with sovereigns, non-financial corporates, and pension funds. These proposals are set out in more detail in the 'Calibration of capital requirements for derivative exposures (CCR and CVA risk)' section in this chapter.

7.12 The PRA proposes to retain the existing CRR exemption from CVA capital requirements for client clearing transactions, given that the PRA considers their risk to be low due to high levels of collateralisation, and the broader systemic benefits of clearing.

7.13 The PRA notes that HMT proposes to retain the existing CRR exemption from CVA capital requirements for specific intragroup exposures that meet the requirements set out in the European Market Infrastructure Regulation (EMIR). Under this approach, intragroup transactions may be exempted from CVA capital requirements where certain conditions are met. For cross-border groups, EMIR requires the group counterparty be established in a third country that has an equivalence determination under Article 13 of EMIR.

7.14 Consistent with the flexibility intended to be provided by HMT for the PRA to create firm-specific rules for intragroup exposures, the PRA also proposes that, as an additional approach, following notification to the PRA, both domestic and cross-border intragroup transactions would be exempt from CVA capital requirements if firms meet the following conditions:

- firms include in the same accounting or prudential consolidation all counterparties to which the exemption would be applied;
- both the counterparty and the firm are subject to appropriate centralised risk evaluation, measurement, and control procedures; and
- there are no current or foreseen material practical or legal impediments to the prompt transfer of own funds or repayment of liabilities from the counterparty to the firm.

Proposed transitional arrangement for legacy trades

7.15 The PRA proposes to apply a transitional arrangement to CVA capital requirements for legacy trades with previously exempt counterparties. Legacy trades that would be exempt from CVA capital requirements immediately before application of these requirements would continue to be exempted from CVA capital requirements for five years following the implementation of the proposals set out in this Consultation Paper (CP). However, the PRA proposes firms may opt not to apply this transitional arrangement and can include legacy trades with previously exempt counterparties in their CVA capital requirements.[3] Where firms choose not to apply the transitional arrangement to individual trades upon implementation of the proposals set out in this CP, the transitional arrangement could not be applied to these trades at a later date. As the total amount of capital requirements for derivative exposures to counterparties is determined by the CVA and CCR frameworks, this proposal should be considered alongside a related transitional arrangement for the targeted recalibration of the SA-CCR framework, described in the 'Calibration of capital requirements for derivative exposures (CRR and CVA risk)' section in this chapter.

> **Question 43: Do you consider the proposed CVA transitional arrangement appropriate from risk and operational perspectives?**

PRA objectives analysis

7.16 The proposals in this section are intended to ensure that CVA capital requirements are commensurate with the risk from transactions that firms engage in, and therefore support the PRA's primary objective of promoting safety and soundness of firms.

7.17 The global financial crisis demonstrated the materiality of CVA risk to firms. Under the CRR, transactions with certain counterparties are exempted from CVA capital requirements. In some cases, CVA risks arising from transactions with sovereigns, non-financial counterparties, and pension funds could be material, and the PRA does not consider it to be prudentially sound for there to be no capital held against CVA risks. The proposals set out in this section would aim to ensure that, in those cases, adequate capital is held. These proposals, combined with the proposed recalibrated SA-CCR for certain counterparties (section 'Calibration of capital requirements for derivative exposures (CCR and CVA risk)'), would result in a risk framework that advances the PRA's safety and soundness objective.

7.18 In contrast, the PRA considers that client clearing trades have immaterial CVA risk due to high levels of collateralisation. Given this, and the broader financial stability benefits that arise from client clearing, the PRA considers that the proposal to retain the exemption for client clearing transactions remains consistent with promoting the safety and soundness of firms.

7.19 Similarly, the PRA considers that it would be consistent with its primary objective for intragroup transactions that have immaterial CVA risk to continue to be exempt from CVA capital requirements. The proposed conditions for the additional approach for intragroup trades would aim to ensure only those transactions with immaterial CVA risk on a firm-specific basis would be exempted from CVA capital requirements.

7.20 The PRA considers that the proposal to provide an additional approach for firms to exempt intragroup transactions from CVA capital requirements, which is not linked to equivalence determinations under EMIR, would facilitate effective competition by providing a means for a wider range of firms to apply the exemption.

'Have regards' analysis

7.21 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Relative standing of the UK as a place to operate (FSMA CRR rules) and competitiveness (HMT recommendation letter):

- The PRA considers its proposals would improve the alignment of the UK's rules with most other jurisdictions. As such, they would enable firms operating in the UK, both domestic and global, to apply a more consistent approach to CVA risk across their businesses. By removing the existing exemptions, the proposed approach provides regulatory certainty to firms operating within the UK while providing a proposed transitional arrangement that gives firms time to adjust their portfolios and for legacy trades to mature.

- The introduction of an additional approach for intragroup transactions, in addition to the existing link to EMIR equivalence, would also provide greater regulatory certainty for international groups operating in the UK.
- The PRA considers that the overall impact on the UK's relative standing as a place to operate should be viewed in combination with the targeted reductions in the calibration of SA-CCR covered in the 'Calibration of capital requirements for derivative exposures (CCR and CVA risk)' section in this chapter.

2. Finance for the real economy (FSMA CRR rules) and sustainable growth (FSMA regulatory principles):

- The PRA has reviewed the available evidence, including a derivatives pricing survey conducted in 2021, and considers that increases or decreases to CVA capital requirements are not automatically passed on to counterparties through higher, or lower prices. Derivatives are part of a broader product set offered to firms' clients, and firms regularly cross-subsidise between products. To the extent any cost is passed on, it is not clear to the PRA that these costs are economically material, or disproportionate to the risk. Most jurisdictions (eg USA, Switzerland, Australia, Hong Kong, Singapore, and Canada) do not provide for similar CVA exemptions to those in the CRR, and the PRA has not seen evidence that this lack of exemptions has been problematic in those jurisdictions. In light of evidence of the limited impact of regulatory costs on derivatives pricing, and the broader drivers of client demand beyond derivatives, the PRA does not consider that the removal of certain CVA exemptions would impact the provision of finance to the real economy and its support of sustainable growth.

3. Relevant international standards (FSMA CRR rules):

- The PRA considers that the proposals would be materially aligned with international standards, and significantly more so than if the existing exemptions were maintained.

4. Proportionality (FSMA regulatory principles and Legislative and Regulatory Reform Act 2006):

- The proposals in this section support the proportionality of the framework by more closely aligning risk with capital requirements. The proposals would also simplify the processes required by firms in monitoring the application of a range of exemptions.

Eligibility for different approaches

7.22 Consistent with the Basel 3.1 standards, the PRA proposes to introduce the three new CVA risk methodologies. The implementation of these methodologies would remove the use of internal models, which the PRA considers would improve consistency across firms. As such, the PRA proposes to implement new eligibility conditions to use the different approaches, which would be included in the Credit Valuation Adjustment Risk Part of the PRA Rulebook.

7.23 Consistent with the Basel 3.1 standards, the AA-CVA would allow firms to calculate the CVA capital requirement by holding an additional 100% of their counterparty credit risk capital requirements. The PRA proposes that the AA-CVA would be available to a firm if its aggregate notional amount of non-centrally cleared derivatives is less than or equal to GBP 88 billion.[4] The PRA proposes that firms would pre-notify the PRA if they intend to use the AA-CVA. The PRA would consider use of its firm-specific requirements powers under FSMA to remove this option for a firm where it considers the approach does not adequately reflect risk for the firm.

7.24 The BA-CVA is a simplified methodology to measure CVA risk intended, in the Basel 3.1 standards, to be available to all firms. Consistent with those standards, the PRA proposes that no approval or notification would be needed for firms to use BA-CVA.

7.25 Consistent with the Basel 3.1 standards, the PRA proposes that firms would need to receive an initial permission to be able to use SA-CVA, the most advanced CVA risk approach in the Basel 3.1 standards. The permission could cover a firm's entire portfolio of covered transactions or a subset of the portfolio. In addition, an annual attestation that the firm continues to meet the requirements for use of SA-CVA would be expected. The PRA's proposed expectations for the attestation are set out in Appendix 17, in the PRA's draft amendments to SS12/13.

7.26 Consistent with the Basel 3.1 standards, the PRA proposes that firms may use a combination of BA-CVA and SA-CVA, but firms would need to justify their approach to the PRA when applying to use SA-CVA. Firms using AA-CVA would not be able to use any other method for calculating CVA capital requirements.

7.27 As detailed in the 'standardised approach (SA-CVA)' section in this chapter, firms using SA-CVA would be allowed to proxy credit spreads for the calculation of the probability of default (PD) by using one of three methodologies. If firms intend to use proxy credit spreads, the PRA proposes that as part of their application for permission to use SA-CVA, firms would be required to set out clear policies for when and how they would use each of the three methodologies.

PRA objectives analysis

7.28 The PRA considers that introducing the three methodologies advances the PRA's primary objective of safety and soundness. The PRA considers that AA-CVA would be a simple, conservative methodology appropriate for smaller firms. BA-CVA would provide a more risk-sensitive approach to estimating risks for firms with moderate CVA risk, while SA-CVA would provide an appropriate level of risk-sensitivity for firms with material CVA risks. The proposed CVA risk framework would advance the PRA's primary objective by enhancing firms' capture of CVA risk in their capital requirements, according to the size and complexity of their derivatives activities. Moreover, the removal of the internal modelled approach should advance the PRA's primary objective by improving consistency in calculating CVA capital requirements across firms.

7.29 The PRA further considers that the proposals would support its secondary objective by reducing excessive variability from the current use of internal models and providing greater comparability of outcomes between firms across different approaches. Eligibility for the AA-CVA, as well as the BA-CVA, would enable firms with smaller derivatives business to compete effectively for business where the derivatives sought by clients may be ancillary to the commercial relationship.

'Have regards' analysis

7.30 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Relevant international standards (FSMA CRR rules):

- The PRA's proposals on available approaches and eligibility align with the Basel 3.1 standards.

2. Proportionality (FSMA regulatory principles and Legislative and Regulatory Reform Act 2006):

- The PRA considers that the proposal to implement three different methodologies, each with a different level and risk-sensitivity, would provide an appropriate range of alternatives that are proportionate to the levels of CVA risk faced by different firms.

3. Efficient and economic use of PRA resources (FSMA regulatory principles):

- The proposals would deploy PRA resources efficiently by restricting the approval process to firms wishing to use the more risk-sensitive SA-CVA. The PRA considers that its proposal would simplify the permissions process for those firms using the more advanced approaches.

The alternative approach

7.31 The Basel 3.1 standards introduce an alternative approach (AA-CVA) for firms with limited non-centrally cleared OTC derivatives (based on notional amounts).

7.32 Firms using the AA-CVA would set their CVA capital requirements equal to 100% of their CCR capital requirements.

7.33 The PRA proposes to introduce the AA-CVA into the Credit Valuation Adjustment Risk Part to provide a proportionate but conservative approach to measuring CVA risk for those firms with minimal non-centrally cleared OTC derivatives exposures.

PRA objectives analysis

7.34 The PRA considers that introducing the AA-CVA advances the PRA's primary objective of safety and soundness by allowing firms with smaller derivatives business to hold adequate capital for CVA risk in their portfolio in a simplified manner that reflects the sophistication of their risks and operations.

7.35 The PRA considers its proposal supports competition by improving the relativity between simpler and more advanced CVA methodologies. Under the CRR, the simplest methodology to measure CVA risk would require firms to multiply their CCR exposure calculated under the most conservative CCR methods by a factor of 10. Consistent with the Basel 3.1 standards, the AA-CVA would instead multiply the CCR exposures calculated under any CCR method by a factor of 1. The PRA considers that the implementation of the AA-CVA would, for firms with limited derivative activities, impose minimal CVA-related operational costs, reducing the barriers to entry to engaging in derivatives activity, and would make smaller firms that use this approach more competitive.

'Have regards' analysis

7.36 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Proportionality (FSMA regulatory principles and Legislative and Regulatory Reform Act 2006):

- The PRA considers that the AA-CVA would enhance the proportionality of the CVA risk framework by providing a simple, conservative approach for measuring CVA risk for firms with limited derivatives activity.

The basic approach

7.37 The Basel 3.1 standards introduce the basic approach (BA-CVA). The approach comprises two methodologies, the 'reduced' BA-CVA, and the 'full' BA-CVA, and would require firms to:

- calculate CVA capital requirements either via a reduced version or full version of the BA-CVA. The reduced version is a simplified methodology for firms that do not hedge CVA risk. The full version of BA-CVA is intended for firms that hedge the counterparty credit spread component of CVA risk;
- calculate CVA capital requirements per counterparty on a stand-alone basis, using a methodology which:
  - maps the counterparty to its relevant risk category to determine the risk weight;
  - takes into account the exposure, maturity (maturity adjustment factor), and a supervisory discount factor in each netting set; and
- aggregate stand-alone CVA capital requirements using a formula that recognises a fixed correlation between counterparty credit spreads.

7.38 The BA-CVA full version recognises the effect of counterparty credit spread hedges. Consistent with the Basel 3.1 standards, the PRA proposes that where a netting set is subject to BA-CVA capital requirements, it may cap the maturity adjustment factor to 1 in the internal ratings based (IRB) approach risk weight formula for CCR (see also Chapter 4 – Credit risk – internal ratings based approach).

7.39 The PRA proposes to implement both the reduced and full versions of the BA-CVA, aligned with the Basel 3.1 standards, as set out below. However, the PRA proposes a recalibration of risk weights for transactions with pension fund counterparties, set out in the 'Calibration of capital requirements for derivative exposures (CCR and CVA risk)' section in this chapter.

Reduced BA-CVA

7.40 The reduced BA-CVA calculation is a simplified version of the full BA-CVA calculation.

7.41 Under the PRA's proposals, firms would first calculate CVA capital requirements for a counterparty on a stand-alone basis. This stand-alone CVA capital requirements calculation would reflect the exposure at default of the counterparty, and the volatility of its counterparty credit spread via a risk weight based on its sector and credit quality. The calculation would also consider the effective maturity and a discount factor for each netting set associated to the counterparty. No recognition would be given for hedges.

7.42 The PRA's proposed methodology would then aggregate the stand-alone CVA capital requirements across all counterparties in a way that recognises portfolio diversification. This reflects that some CVA risks are common to all firms (ie systematic risks), and some risks are firm-specific (ie idiosyncratic risks). The final reduced BA-CVA capital requirements would therefore recognise that the portfolio of risks is different from the risks posed by each counterparty in isolation.

Full BA-CVA

7.43 The PRA proposes that the full version of BA-CVA would be a weighted sum of the reduced BA-CVA, and a 'hedged' BA-CVA. The hedged version would be a CVA exposure calculation that recognises the risk-reducing effect of counterparty credit spread mitigants (ie hedges). The full BA-CVA capital requirements would be the sum of 25% of the reduced BA-CVA capital requirements, and 75% of the hedged BA-CVA capital requirements. This aggregation is intended to act as a conservative means to prevent CVA capital requirements reaching zero, to recognise that hedges are not perfect.

7.44 The proposed hedged BA-CVA calculation shares similarities with the reduced BA-CVA. However, the aggregation methodology in the hedged BA-CVA differs as it recognises the reductions in CVA risk arising from (i) hedges that reference single names, in both systematic and idiosyncratic risk, and (ii) hedges that reference indices to reduce systematic risk. The methodology also adjusts the capital requirements to reflect that some components of indirect hedges are not aligned with counterparties' credit spreads.

7.45 The PRA proposes that single-name credit default swaps (CDS), single-name contingent CDS, and index CDS can be eligible CVA hedges in the hedged BA-CVA calculation. Additionally, eligible single-name credit instruments would need to either:

- reference the counterparty directly; or
- reference an entity legally related[5] to the counterparty; or
- reference an entity that belongs to the same sector and region as the counterparty (eg proxy credit spreads).

PRA objectives analysis

7.46 The PRA considers that introducing BA-CVA advances the PRA's primary objective of ensuring the safety and soundness of firms by better aligning capital requirements and risk. The PRA considers that BA-CVA represents an improvement to the existing framework to account for advances in CVA risk estimation and management since the existing methodology was implemented. In particular, it would expand the range of acceptable hedges for firms using the full BA-CVA and would adjust the maturity of transactions for CCR purposes where rating transition risks are otherwise captured.

7.47 The PRA considers that its proposals would advance the PRA's secondary objective of competition, as they would enable firms to engage in derivatives while requiring relatively low CVA-related regulatory operational costs, eg limiting the need for firm-specific inputs.

'Have regards' analysis

7.48 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Relevant international standards (FSMA CRR rules) and relative standing of the UK as a place to operate (FSMA CRR rules):

- The PRA considers that its proposal to introduce the BA-CVA would be a faithful implementation of the methodology set out in the Basel 3.1 standards. The PRA considers that this proposal supports the relative standing of the UK as a place to operate, given that BA-CVA would address the shortcomings in the existing CVA risk framework. This would enhance the UK's reputation for having a robust regulatory environment, thus preserving its position as an attractive domicile for internationally active financial institutions.

2. Proportionality (FSMA regulatory principles and Legislative and Regulatory Reform Act 2006) and different business models (FSMA regulatory principles):

- The PRA considers its proposals would support proportionality of the CVA risk framework. They would implement a relatively simple framework that provides a risk-sensitive methodology for firms wishing to hedge CVA risk, while providing a simple reduced version that is proportionate to the risks for firms that do not actively hedge CVA risk. The introduction of this method would therefore contribute to the adaptability of the proposed framework to different types of business models.

The standardised approach

7.49 The Basel 3.1 standards introduce the standardised approach (SA-CVA) for use by firms that have approval from their supervisors.

7.50 The SA-CVA methodology:

- relies on firm-computed CVA risk sensitivities to counterparty credit spreads and market risk factors, where these sensitivities estimate the movement of CVA risk due to changes in the value of each risk factor ('delta risk'), and changes in the volatility of each risk factor ('vega risk');
- recognises the hedging of both counterparty credit spread and market risk drivers of CVA risk; and
- specifies criteria for the use of substitute data for the calculation of the PD and expected loss given default (ELGD), where spread data is not directly available (known as 'proxy credit spreads').

7.51 The Basel 3.1 standards also specify that where CVA capital requirements for a netting set are calculated using SA-CVA, the IRB risk weight formula for CCR would allow for the maturity adjustment factor to be capped at 1 (see also Chapter 4).

7.52 The PRA considers that the SA-CVA methodology represents an improvement in the consistency of measurement of CVA risk and aligns more closely to the market risk framework. Therefore, the PRA proposes to implement SA-CVA consistent with the Basel 3.1 standards, but with a recalibration of risk weights for pension fund transactions set out in the 'Calibration of capital requirements for derivative exposures (CCR and CVA risk)' section in this chapter.

7.53 The PRA proposes that for permission to be granted to use SA-CVA, a firm would need to demonstrate to the satisfaction of the PRA that:

- it is able to calculate, and report to the PRA, its own funds requirement for CVA risk in accordance with the requirements of the SA-CVA approach;
- it has a CVA desk (or a similar dedicated function) responsible for risk management and hedging of CVA risk; and
- it complies with the SA-CVA qualitative requirements.

Definition of regulatory CVA

7.54 To improve consistency of CVA capital requirement calculations across firms, the PRA proposes that the SA-CVA capital requirements would need to be calculated from a regulatory CVA measure instead of each firm's accounting CVA measure. To achieve greater consistency and to help ensure that accounting CVA best practice is followed, the PRA proposes that regulatory CVA is calculated with specified data necessary for the calculations. Specifically:

- a term structure of market-implied PD that would need to be estimated from observed credit spreads, or proxy credit spreads if these are not available;
- market consensus ELGD, which would need to be calculated by using a risk-neutral PD from credit spreads; and
- simulated paths of discounted future exposure, which would need to be calculated by pricing all derivative transactions with the counterparty along simulated paths of relevant market risk factors.

Calculation methodology

7.55 The PRA proposes that the calculation of SA-CVA capital requirements would rely on firm-computed CVA sensitivities to counterparty credit spreads and market risk factors. These sensitivities would indicate how much the regulatory CVA would fluctuate due to delta risk and vega risk for each risk factor.

7.56 The proposals would require firms to group similar risks into risk classes (eg interest rates). Within each class, firms would then allocate risk drivers into buckets (eg a different tenor of an interest rate curve). CVA risk for delta and vega would then be calculated separately for each bucket, before being aggregated with some recognition of diversification across buckets. The PRA's proposals within each of the above steps include the following elements:

- **Risk classes**: the capital requirements for delta and vega risks would be calculated independently for six risk classes: interest rate; foreign exchange; counterparty credit spread (delta risk only); reference credit spread; equity; and commodity;
- **Risk buckets**: the PRA proposes to define specific buckets within the six risk classes, where firms would calculate CVA capital requirements at a bucket level by aggregating CVA risk sensitivities from each risk factor specific to the risk class, separately for delta and vega risks; and
- **Correlation**: bucket-level capital requirements would be aggregated into CVA capital requirements at risk class level, separately for delta and vega risks, by recognising the correlation between buckets within each risk class.

7.57 The PRA proposes to maintain the existing eligibility of instruments that hedge the counterparty credit spread component of CVA risk. The proposals also recognise hedging instruments which mitigate CVA risk from market risk factors, to better align firms' risk management and CVA capital requirements. Finally, the PRA proposes that both proxy hedges and index hedging are recognised in the SA-CVA methodology. Where the hedge instrument is an index, firms would be required to calculate sensitivities to all risk factors upon which the value of the index depends. Consistent with the Basel 3.1 standards, the PRA proposes that instruments that can be used to hedge two risk classes (eg credit spread risk and reference credit spread) are only applied to one risk class for the purpose of determining CVA capital requirements.

7.58 For firms that have been granted approval for their IRB models, the PRA proposes they would use internal ratings for the purpose of calculating CVA capital requirements for those counterparties where there is no external rating available.

Proxy credit spreads for the calculation of the probability of default

7.59 The credit spreads of a firm's counterparties are a key input into a firm's calculation of regulatory CVA. Where a counterparty's credit spreads are not readily observable, the PRA proposes that firms would use available close substitutes to estimate this risk ('proxy credit spreads'). The PRA proposes three approaches for how firms may proxy credit spreads for counterparties, as detailed below. These approaches are important to provide consistency across firms to calculate similar risks:

1. Using credit spreads observed in the market using a methodology that identifies appropriate peers based on at least the following three factors: a measure of credit quality (eg rating), industry, and region.
2. In certain cases, mapping an illiquid counterparty to a single liquid reference name. In these cases, the PRA proposes that firms would need to be able to justify to its supervisor, if requested, each case of mapping an illiquid counterparty to a single liquid reference name.
3. When no credit spreads of any of the counterparty's peers are available, a more fundamental analysis of credit risk to proxy the spread of an illiquid counterparty. In this case, where historical PDs are used as part of this assessment, the PRA proposes that the resulting spread could not be based on historical PD only; it would need to consider current market-based data.

The calculation of ELGD

7.60 The PRA considers that market-consensus ELGD is a key input into a firm's calculation of CVA capital requirements. It sets out the loss a firm is expected to incur given the default of the counterparty. Consistent with the Basel 3.1 standards, the PRA proposes that firms would need to calculate ELGD using the risk-neutral PD from credit spreads. Where the seniority of derivatives differs from that of senior unsecured bonds, the PRA proposes firms may reflect that difference in ELGD, but would be required to be able to justify such adjustments to their supervisor if requested.

PRA objectives analysis

7.61 The PRA considers that introducing SA-CVA would advance the PRA's primary objective of ensuring the safety and soundness of firms by providing a more risk-sensitive methodology for firms subject to significant CVA risk. Implementing the proposal would better align capital requirements with risk, when compared to existing approaches, by improving recognition of hedging and taking account of a wider range of factors that affect CVA risk.

7.62 The proposal would support the PRA's secondary competition objective by creating greater consistency in CVA capital requirements across firms due to the removal of modelling from the most advanced existing approach.

'Have regards' analysis

7.63 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Relevant international standards (FSMA CRR rules) and relative standing of the UK as a place to operate (FSMA CRR rules):

- The proposals use the same methodologies as set out in the international standards. The PRA considers that this would support the UK's relative standing as a place to operate. SA-CVA would address shortcomings in existing CVA methodologies, notably through recognising movements in the exposure component of CVA, as well as expanding the scope of hedge recognition. These changes would serve to enhance the UK's reputation for having a robust regulatory environment, thereby preserving its position as an attractive domicile for internationally active firms.

2. Proportionality (FSMA regulatory principles and Legislative and Regulatory Reform Act 2006) and different business models (FSMA regulatory principles):

- The proposals would provide a risk-sensitive methodology for determining capital requirements for firms with substantial CVA risk. By standardising many elements of the methodology, it provides a proportionate balance between simplicity and risk-sensitivity where necessary, through targeted use of firms' own estimates, including incorporating firms' market risk estimates where relevant. The PRA considers that this proposal has had regard to different business models, as SA-CVA would be the most complex methodology and is intended for firms with large derivative activities that actively manage CVA risk. The permissions regime would allow the PRA to assess whether the firms have the appropriate skill and expertise to utilise SA-CVA.

3. Efficient and economic use of PRA resources (FSMA regulatory principles):

- The PRA considers that the proposed permissions regime, including the annual attestation process, would be an efficient and economic use of the PRA's resources. It would enable the PRA to focus its resources into the areas of most risk or prudential concern in relation to CVA risk.

Calibration of capital requirements for derivative exposures (CCR and CVA risk)

7.64 In 2021, the PRA implemented the Basel SA-CCR methodology. In feedback provided to responses received as part of the consultation process,[6] the PRA noted that it would holistically review the overall level and balance of capital requirements for derivatives exposures in both the SA-CCR and CVA risk frameworks as part of the implementation of the Basel 3.1 CVA risk framework.

Calibration of SA-CCR alpha factor, CVA calibration, and exemptions

7.65 The PRA has considered the aggregate capital requirements from SA-CCR and the Basel 3.1 CVA risk framework. As a result, the PRA proposes to:

- reduce the SA-CCR 'alpha factor'[7] from 1.4 to 1 for transactions with pension funds and non-financial counterparties;
- remove the existing exemptions from requiring CVA capital requirements for transactions with sovereigns and non-financial counterparties;
- remove the existing temporary exemption from requiring CVA capital requirements for transactions with pension funds, and introduce a new risk weight category for pension funds in BA-CVA and counterparty credit spread delta risk calculations in SA-CVA, which would reduce the calibration set out in the Basel 3.1 standards;
- introduce an additional approach for firms to apply the intragroup exemption directly into the PRA Rulebook; and
- retain the exemption from requiring CVA capital requirements for client clearing transactions.

7.66 The proposals would be included in the new Credit Valuation Adjustment Part, and result in amendments to the Counterparty Credit Risk (CRR) Part.

SA-CCR alpha factor

7.67 The PRA has undertaken analysis of data provided by firms on the exposure values for derivatives calculated using SA-CCR and the Internal Models Method (IMM). The PRA's analysis identified that, when compared to IMM exposure estimates, SA-CCR calculates exposure significantly above IMM for pension funds and non-financial counterparties. The PRA considers that the level of conservatism, for exposures to these counterparty types, is excessive. The PRA therefore proposes to reduce the calibration of SA-CCR for these counterparty types. To achieve this overall recalibration, the PRA proposes to reduce the alpha factor from 1.4 to 1 for exposures to non-financial corporates and pension funds.

7.68 The PRA considers that a SA-CCR transitional arrangement linked to the CVA transitional agreement proposed in the 'Scope of application' section in this chapter is necessary to make sure that legacy transactions with non-financial corporates and pension funds benefiting from both the reduction in the alpha factor and the CVA transitional arrangement would have appropriate capital requirements.

7.69 Since SA-CCR groups together all trades with a counterparty when it calculates exposures, the PRA considers that it is appropriate that firms would be permitted to adopt an alpha factor equal to 1 on both legacy transactions and new transactions with pension funds and non-financial corporates. Firms would, however, be required to hold additional capital in Pillar 1 equal to the day 1 capital benefit from the reduction of the alpha factor for legacy trades. This add-on would be reduced linearly over five years, or until all trades with counterparties where alpha is set to one are voluntarily incorporated into the CVA calculation of capital requirements. The PRA considers the alternative approach - requiring firms to split netting and hedging into legacy trades and new trades - would impose a disproportionate operational burden on firms.

Question 44: Do you consider the SA-CCR transitional arrangement appropriate from risk and operational perspectives?

CVA exemptions

7.70 The CRR currently exempts several types of transactions from CVA capital requirements:

- transactions with sovereigns that meet specified conditions (set out in CRR Article 382(4)(d));
- transactions with UK non-financial counterparties and third country non-financial counterparties below the clearing threshold (set out in CRR Article 382(4)(a));
- a temporary exemption for transactions with pension funds, while there remains an exemption from the pension fund clearing obligation (set out in CRR Article 382(4)(c));
- client clearing transactions (set out in CRR Article 382(3)); and

- intragroup transactions with counterparties that meet specified conditions (set out in CRR Article 382(4)(b)).

7.71 As noted in the ‘Scope of application’ section in this chapter, given the potentially material risks these transactions pose, the PRA proposes to remove the exemption on exposures to pension funds, non-financial corporates, and sovereign transactions. The PRA also proposes to introduce a five-year transitional arrangement for these CVA legacy trades, as noted in the ‘Scope of application’ section.

7.72 The PRA considers however, that while pension funds should be in scope of CVA capital requirements, the treatment of pension funds in the Basel 3.1 standards may be overly conservative. The Basel 3.1 standards apply the same treatment to pension funds as all other types of financial services counterparties, which may not be sufficiently granular given the differing risk profiles. To address this concern, the PRA proposes to introduce a separate risk weight for pension funds. Pension funds would receive a risk weight of 3.5% for investment grade, and 8.5% for unrated and high yield exposures, both in BA-CVA and in SA-CVA. This represents an approximately 30% reduction compared to the Basel 3.1 standards.

7.73 As noted in the ‘Eligibility for different approaches’ section in this chapter, the PRA proposes to maintain the existing CVA exemption for client clearing trades, and introduce an additional approach where intragroup trades are likely to have immaterial CVA risk.

> **Question 45: To what extent do you consider the targeted recalibration on risk weights for pension funds and the proposed reduction in the SA-CCR alpha factor to be appropriate?**

PRA objectives analysis

7.74 The proposals would advance the PRA’s primary objective of ensuring the safety and soundness of firms by ensuring that material risks are not exempted from CVA capital requirements. The PRA considers that it is prudentially sound to exempt client clearing transactions, given their very low risk nature, and the broader financial stability value of continuing to support client clearing. The PRA also considers that the intragroup exemption would not give rise to safety and soundness concerns due to the low CVA risk of those transactions. However, the global financial crisis demonstrated the materiality of CVA risk to firms. Under the CRR, transactions with certain counterparties are exempted from CVA capital requirements. Data provided to the PRA by firms in 2021 shows that CVA risk for transactions with certain sovereigns, non-financial counterparties, and pension funds is material. The PRA does not consider exempting them from capital requirements to be prudentially sound. The proposals would aim to ensure that in those cases adequate capital is held.

7.75 The PRA considers the data it has collected shows that, for some counterparties, the SA-CCR calibration compared to IMM is overly conservative. The PRA considers it appropriate that targeted recalibrations can be made without undermining the safety and soundness of firms. The PRA considers that, by implementing targeted recalibrations of the SA-CCR and CVA risk frameworks for certain exposures, the PRA would be improving risk-sensitivity by ensuring the risks are captured appropriately.

7.76 The PRA considers that the proposed package of amendments across the two frameworks would not materially impact effective competition between firms. Competition in derivative markets depends on many factors, of which capital requirements is a relatively small element. The CVA proposals would apply consistently across the BA-CVA and SA-CVA approaches, and the SA-CCR proposals reduce the over-calibration of SA-CCR relative to IMM, which make it a more credible alternative to IMM for firms.

'Have regards' analysis

7.77 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Relative standing of the UK as a place to operate (FSMA CRR rules) and competitiveness (HMT recommendation letter):

- The PRA considers its proposals would improve the alignment of the UK with the majority of other jurisdictions. For example, USA, Switzerland, Australia, Hong Kong, Singapore, and Canada, among others, do not have CVA exemptions. As such, the PRA's proposals would enable both domestic and global firms operating in the UK to apply a more consistent approach to CVA risk and CVA capital requirements across their businesses. By removing temporary exemptions, the proposed approach would provide regulatory certainty to firms operating within the UK.
- The PRA considers its proposed CCR and CVA recalibration and exemptions package balances the reduction in the alpha factor with the removal of specific exemptions and is justified by data. The evidence the PRA has available indicates that the nature of client relationships are driven by a wider set of products beyond derivatives pricing alone. The PRA, therefore, considers that these proposals would not materially affect the competitiveness of the UK.

2. Relevant international standards (FSMA CRR rules):

- The PRA considers that the proposals would be materially aligned with international standards, and significantly more so than if the existing exemptions were maintained.

3. Finance for the real economy (FSMA CRR rules) and sustainable growth (FSMA CRR rules):

- Having appropriate capital requirements for CVA risk is important to support firms' robustness to market movements and ability to provide finance in the medium term, supporting sustainable growth. The PRA considers available evidence from firms demonstrates that changes to CVA capital requirements are not consistently passed on to counterparties through higher or lower prices. To the extent such costs are passed on, it is not clear that they are economically material, or disproportionate to the risk.
- The PRA is not aware of evidence from jurisdictions that have not had CVA exemptions over the last decade that this has impacted the provision of finance to the real economy or sustainable growth. The PRA considers that the reduction of the alpha factor balances any potential impact of removal of CVA exemptions.
- Consequently, the PRA considers that the proposed package across the two frameworks as a whole would not give rise to concerns that provision of finance to the real economy and sustainable growth may be negatively impacted.

4. Proportionality (FSMA regulatory principles and Legislative and Regulatory Reform Act 2006):

- The PRA considers its proposals are proportionate as they more closely align risk with capital requirements. The proposals simplify the approach required by firms in removing the complicated set of exemptions and align with accounting CVA.

Question 46: To what extent do you think the proposed CVA and SA-CCR package appropriately aligns the risks with the capital requirements for derivatives transactions?

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1. See Chapter 2 – Scope and levels of application, which also describes the position for PRA-designated financial holding companies or mixed financial holding companies related to those UK banks and building societies.
2. As set out within the definition of 'covered transaction' in the Credit Valuation Adjustment Risk Part of the PRA Rulebook.
3. The PRA believes firms may choose not to apply the transitional for operational reasons or to realise netting and hedging benefits.
4. As proposed in Chapter 13 – Currency redenomination, to best reflect the EUR 100 billion threshold stated in the Basel 3.1 standards.

5. Where the reference name and the counterparty are either a parent undertaking and its subsidiary, or two subsidiaries of a common parent undertaking.

6. PRA Policy Statement 17/21 – **'Implementation of Basel Standards'**, July 2021. See chapter 9 'Counterparty credit risk'.

7. The alpha factor is a multiplier carried over from the alpha value set by the BCBS for the Internal Model Method (IMM) into SA-CCR.

Appendices

Appendix 4: Draft PRA Rulebook (CRR) Instrument [2023] (PDF 4.1MB)

Appendix 17: Draft amendments to Supervisory Statement SS12/13 – Counterparty credit risk (PDF 1.5MB)

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CP16/22 – Implementation of the Basel 3.1 standards: Operational risk

Chapter 8 of CP16/22

Published on 30 November 2022

Content

Overview

8.1 This chapter sets out the Prudential Regulation Authority's (PRA) proposals to implement the Basel 3.1 standards for operational risk. The operational risk capital framework aims to ensure that firms' operational risk capital requirements adequately reflect the risks posed from inadequate or failed internal processes, people or systems, or from external events. Operational risk also includes legal risk.

8.2 The proposals in this chapter would:

- introduce the new requirements for operational risk in a new Operational Risk Part of the PRA Rulebook; and
- revoke the Operational Risk (CRR) Part of the PRA Rulebook, which replicated Article 316 of the CRR in PRA rules as part of PRA Policy Statement 17/21 – **'Implementation of Basel standards'**.

8.3 The proposals would also delete Supervisory Statement (SS) 14/13 '**Operational risk**', which sets out the PRA's expectations in relation to the advanced measurement approach, which would become obsolete.

8.4 The following policy proposals are set out in this chapter:

- to implement the new standardised approach (SA) for Pillar 1 operational risk capital requirements; and
- to exercise the national discretion to set the internal loss multiplier (ILM) equal to 1.

8.5 The Basel Committee on Banking Supervision (BCBS) concluded that the global financial crisis highlighted that operational risk capital requirements were not sufficient to cover the losses incurred by some firms. It also highlighted that sources of these losses – including those related to fines for misconduct or poor controls – were difficult to predict using internal models. This indicated that the existing set of simple approaches for operational risk – the basic indicator approach (BIA) and the standardised approach (SA), including its variant the alternative standardised approach (ASA) – and the advanced measurement approach (AMA), did not generate sufficiently accurate operational risk capital requirements relative to operational risks for a wide spectrum of firms.

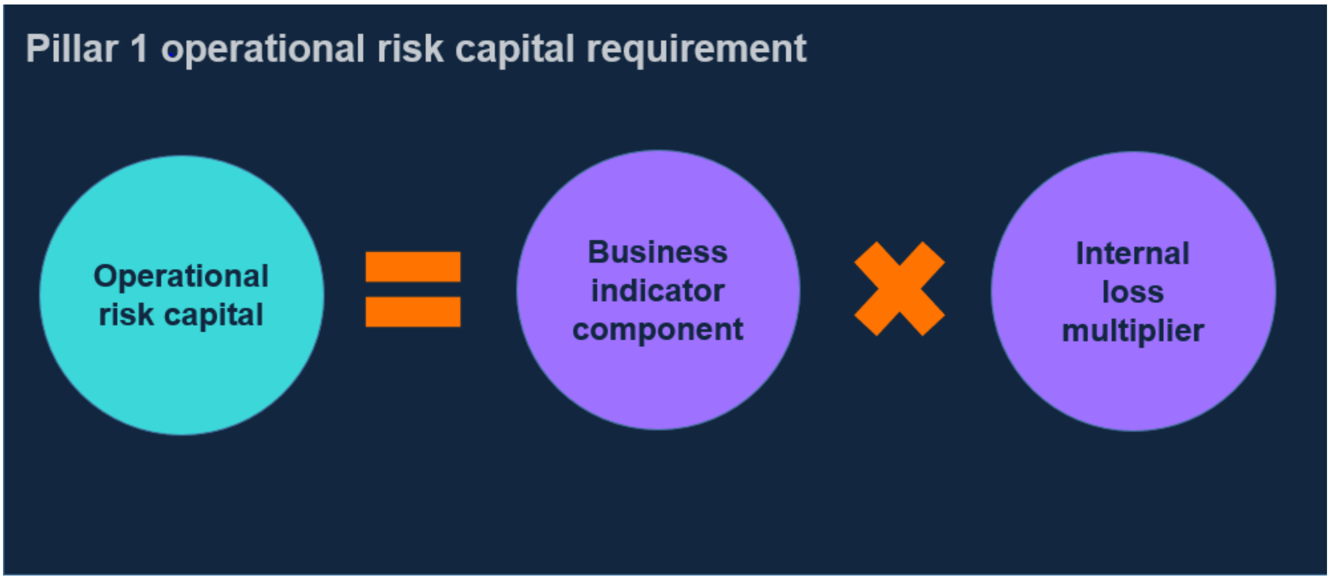
8.6 In response, the BCBS designed a new operational risk framework that replaces all existing operational risk approaches for calculating Pillar 1 operational risk capital (ORC) requirements with a single standardised approach – the SA. The PRA considers that implementation of the SA would enhance the safety and soundness of firms. It would also facilitate a better comparison of risk-weighted assets (RWAs) between firms by removing the use of multiple concepts and methods, and removing the use of firms' internal models for estimating operational risk.

8.7 The proposals in this chapter are relevant to PRA-authorised banks, building societies, PRA-designated investment firms, and PRA-approved or PRA-designated financial holding companies or mixed financial holding companies ('firms'). The proposals would not apply to UK banks and building societies that meet the Simpler-regime criteria and choose to be subject to the Transitional Capital Regime proposals.[1]

Implementation of the standardised approach in PRA rules

8.8 The PRA proposes to implement the SA in the Basel 3.1 standards for Pillar 1 operational risk capital requirements in PRA rules. The PRA also proposes to retire the CRR Pillar 1 operational risk framework and SS14/13 - 'Operational risk'.

8.9 Consistent with the Basel 3.1 standards, the PRA proposes to introduce a new calculation for Pillar 1 operational risk capital requirements calculated as follows:



8.10 The business indicator component (BIC) is a measure of firm size and economic activity, and is used as a proxy for operational risk on the basis that the larger and more active the firm, the greater the potential exposure to operational risk.

8.11 The ILM is intended to make a firm's operational risk capital requirements sensitive to its operational loss history. The Basel 3.1 standards include a national discretion to neutralise the impact of historical internal operational risk losses by setting the ILM equal to 1. If this discretion is applied, then a firm's operational risk capital requirements would not be mechanically linked to its past loss history. The PRA proposes exercising national discretion to set the ILM equal to 1 (see 'Exercise national discretion to set the ILM equal to 1' section later in this chapter). The PRA also proposes to continue to apply supervisory judgement regarding the relevance of past losses to future operational risk by using its more sophisticated approach in the Pillar 2A framework as set out in its Statement of Policy **'The PRA's methodologies for setting Pillar 2 capital'**.

8.12 As a general principle, the PRA does not intend to require firms to calculate capital requirements for the same risk under both the Pillar 1 and Pillar 2 frameworks (see Chapter 10 – Interactions with the PRA's Pillar 2 framework). To the extent that the proposals in this chapter improve operational risk capture in Pillar 1, the Pillar 2A operational risk capital requirements would adjust by an offsetting amount in line with the PRA's existing approach to Pillar 2A. Therefore, the PRA considers that there would be no material impact on firms' total Pillar 1 plus Pillar 2A operational risk capital requirements.

8.13 The PRA also proposes to maintain the requirements in relation to policies and processes set out in the CRR for a firm to evaluate and manage its exposure to operational risk.

Calculation of the business indicator component (BIC)

8.14 The BIC is calculated by multiplying the business indicator (BI) – as defined below – by defined marginal coefficients (α_i). The BI is a financial statement-based proxy for operational risk and includes three components, all comprising of specific combinations of profit and loss items:

- the interest, leases, and dividend component (ILDC);
- the services component (SC); and
- the financial component (FC).

8.15 The PRA proposes to explicitly set out, in PRA rules, the items to be included in each of the three BI components (see the table set out in 'Annex 1 – Business Indicator Components' of the Operational Risk Part of the PRA Rulebook). The PRA expects that the majority of firms already collect and store these data items.

8.16 The BI is calculated as a three-year simple average of ILDC + SC + FC, taking those components as at a firm's financial year end. Where a firm has been in operation for less than three years, in the existing framework, the PRA permits the use of forward-looking estimates in calculating the BI, provided that the firm begins using historical data as soon as it is available. The PRA considers it would be prudent and proportionate to maintain this flexibility in the PRA rules.

8.17 The Basel 3.1 standards require that the BI includes items that result from acquisitions of relevant businesses and mergers. Where a firm can prove that, due to a disposal of entities or activities, using a three-year average to calculate the BI would lead to a biased estimation of the operational risk capital requirements, it may request supervisory approval to exclude divested activities from the calculation of the BI. The PRA proposes to implement an approval process for such cases in line with the existing approval process for CRR Articles 315(3) and 317(4).[2]

8.18 The marginal coefficients (α_i) set out in the Basel 3.1 standards increase with the size of the BI, as shown in the table below. The BI places firms in different 'buckets' according to their income; the higher the BI, the higher the marginal coefficient. For example, for firms in the first bucket (ie BI less than or equal to £0.88 billion),[3] the BIC would be equal to BI x 12%. For firms in the second bucket (ie BI above £0.88 billion and below or equal to £26 billion), the marginal coefficient for every unit of BI above £0.88 billion would increase to 15%, so the BIC would be equal to (0.88 x 12%) + ((BI - 0.88) x 15%). Finally, firms in the third bucket (ie BI above £26 billion) would apply a marginal coefficient of 18% for every unit of BI above £26 billion.[4] This approach is intended to reflect that larger firms are more complex and therefore proportionately more exposed to operational risk.

BI ranges and marginal coefficients

Bucket	BI range (in £ billion)	BI marginal coefficient (α_i)
1	≤ 0.88	12%
2	0.88 < BI ≤ 26	15%
3	> 26	18%

8.19 The PRA proposes to adopt the marginal coefficients as set out in the Basel 3.1 standards. The BIC contrasts with the proxy indicators currently used under the CRR in that it introduces the size of a firm's business as a risk driver, as opposed to just relying on gross income.

PRA objectives analysis

8.20 The PRA considers that the SA would enhance risk-sensitivity relative to the CRR. The PRA considers this is particularly the case for the calculation of the BIC, as the size and complexity of firms is a relevant factor in considering operational risk. The approach would also help achieve consistency across firms while maintaining an appropriate level of capital. As such, the approach would advance the PRA's primary safety and soundness objective.

8.21 In adjusting coefficients for the size of firms, the PRA considers the approach would also advance its secondary competition objective as operational risk capital requirements would be relatively higher for larger firms in buckets 2 and 3.

'Have regards' analysis

8.22 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Proportionality (FSMA regulatory principles and Legislative and Regulatory Reform Act 2006):

- The PRA considers that the SA would be proportionate, both through its simplicity of calculation based on financial statement information, and through its differentiation based on a firm's size and complexity. The introduction of a single SA, rather than three alternative approaches as under the CRR, would incur some small costs for firms. However, the PRA considers these would be initial one-off costs, and notes that there would be a reduction in the regulatory burden on firms in terms of the complexity and difficulty in understanding multiple approaches and which approach is most appropriate for the firm.

2. Sustainable growth (FSMA regulatory principles):

- Operational risk exposures accrue differently from credit risk and market risk. A firm could have low credit exposures but still run substantial operational risks (eg custodian banking activities). The BIC would aim to ensure firms calculate adequate capital requirements against operational risk. This, in turn, would enable firms to continue to provide banking services to the real economy when operational risks crystallise, therefore supporting sustainable growth.

> **Question 47: Do you have any comments on the PRA's proposed implementation of the SA in the Basel 3.1 standards for operational risk capital requirements?**

Exercise national discretion to set the Internal Loss Multiplier (ILM) equal to 1

8.23 The PRA proposes to exercise the national discretion in the Basel 3.1 standards to set the ILM equal to 1.[5] The ILM takes into account past operational risk losses via the loss component (LC), which is equal to 15 times average annual operational risk losses incurred by the firm over the previous 10 years. Where the LC is greater than the BIC (ie actual losses exceed the proxy for losses), the ILM is greater than 1; and where the LC is lower than the BIC, the ILM is less than 1. The Basel 3.1 standards include a national discretion to neutralise the impact of historical internal operational risk losses by setting the ILM equal to 1.

8.24 The PRA considers a mechanical link to past losses to be inappropriate for the following reasons:

- The calculation of the ILM is non-linear – operational risk capital requirements increase more slowly as historical losses increase. The PRA considers that, particularly for situations of large historical losses, more flexible and risk-sensitive approaches are appropriate, including the PRA's Pillar 2A methodology.[6]
- Calculating capital requirements for operational risk is a significant challenge. The loss distribution is unusually 'fat-tailed', characterised by infrequent but very large losses, and there is a paucity of data. The PRA considers that low-probability high-impact events, given their heterogeneity, are generally not good predictors of other unlikely events and therefore future losses. In these situations, the ILM may not be sufficiently risk-sensitive.
- The PRA considers that the information value of operational risk losses generally diminishes over time as business models and lending activities change. The SA's use of a 10-year window of unweighted past losses in the ILM could result in it being inappropriately affected by large historical operational risk losses near the start of the 10-year period that might be weak predictors of future losses.

8.25 However, the PRA recognises that historical losses can provide important information when considering operational risk. It is important to monitor and assess the magnitude of operational risk events as part of the Pillar 2 review of firms' capital adequacy. The PRA already has a sophisticated approach to calculating Pillar 2A operational risk capital requirements, which includes using loss estimates based on a firm's forecast, historical losses, scenario analysis, and supervisory judgement to inform the setting of a firm's operational risk add-on. The PRA proposes to continue to use that approach, which applies supervisory judgement regarding the relevance of past losses to future exposure to operational risk.

8.26 As a general principle, the PRA framework does not intend to double count capital requirements for the same risks in Pillar 1 and Pillar 2A. To the extent that the proposals in this CP improve operational risk-capture in Pillar 1, under the PRA's existing policy, the Pillar 2A operational risk capital requirements would adjust accordingly (Chapter 10).

PRA objectives analysis

8.27 The PRA considers that by continuing to apply supervisory judgement regarding the relevance of past losses to future operational risk using its more sophisticated approach in the Pillar 2A framework, this proposal would maintain the safety and soundness of firms by ensuring operational risk capital requirements are risk-sensitive.

8.28 The PRA considers that the proposals set out in this section should not have any significant implications for facilitating effective competition. The proposal to set the ILM equal to 1 would mean Pillar 1 operational risk capital requirements would be solely dependent on a proxy of a firm's gross income and size. As a result, the SA would be based on the BIC and have a different impact on different firms reflecting their size and complexity. The PRA considers this would be a suitable outcome as evidence suggests that the size of a firm is the dominant differentiator of operational risk.[7] In addition, the PRA considers that no particular business model is likely to be disproportionally affected by setting the ILM equal to 1. In contrast, applying a variable ILM could have different, and possibly material, impacts on different firms with different business models, which could have unintended consequences for competition.

'Have regards' analysis

8.29 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Finance for the real economy (FSMA CRR rules):

- The PRA considers the proposal to set the ILM equal to 1 would help ensure that there would be no material impact on firms' total Pillar 1 plus Pillar 2A operational risk capital requirements – notably due to the flexibility the PRA has under its existing Pillar 2A methodology. As a result, the proposals should not have an impact on finance for the real economy.

2. Relevant international standards (FSMA CRR rules):

- The PRA's proposals would align with the Basel 3.1 standards by exercising the national discretion to set the ILM equal to 1.

Question 48: Do you support the PRA's proposal to set the ILM equal to 1?

1. Chapter 2 – Scope and levels of application also describes the position for PRA-designated financial holding companies or mixed financial holding companies related to those UK banks and building societies.
2. The PRA expects all permissions granted under CRR Article 315(3) and 317(4), as at 31 December 2024, to be saved by HM Treasury for firms implementing the Basel 3.1 standards. This would result in permissions granted under Article 315(3) and 317(4) being deemed to be permissions under new Rule 5.5(2) of the Operational Risk Part. For TCR firms, see paragraph 2.26 of Chapter 2.
3. The PRA proposes that thresholds stated in EUR or USD in the Basel 3.1 standards are converted into GBP (see Chapter 13 – Currency redenomination).
4. For example, given a BI = £35 billion, the BIC = (0.88 x 12%) + ((26-0.88) x 15%) + ((35-26) x 18%) = £5.49 billion.
5. The Basel 3.1 standard requires that to aid comparability, all firms would be required to disclose their historical operational risk losses, even in jurisdictions where the ILM is set to 1. Disclosure and reporting implications are covered in Chapter 11 – Disclosure (Pillar 3) and Chapter 12 – Reporting.
6. PRA Statement of Policy – **'The PRA's methodologies for setting Pillar 2 capital', July 2021.**
7. BCBS **'Operational risk – Revisions to the simpler approaches'**.

Appendices

Appendix 4: Draft PRA Rulebook (CRR) Instrument [2023] (PDF 4.1MB)

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CP16/22 – Implementation of the Basel 3.1 standards: Output floor

Chapter 9 of CP16/22

Published on 30 November 2022

Content

Overview

9.1 This chapter sets out the Prudential Regulation Authority's (PRA) proposals to implement the Basel 3.1 standards for the output floor with respect to firms' calculation of own funds requirements.

9.2 The PRA understands that HM Treasury (HMT) intends to revoke Article 92 of the Capital Requirements Regulation (CRR). Accordingly, this chapter proposes to introduce a new Required Level of Own Funds (CRR) Part of the PRA Rulebook to reflect the implementation of the output floor.

9.3 The PRA proposes to implement the output floor as follows:

- to introduce a floor on risk-weighted assets (RWAs) that would require relevant firms with internal model (IM) permissions to calculate RWAs as the higher of: (i) the total RWAs calculated using all approaches that they have supervisory approval to use (including IM approaches); or (ii) 72.5% of RWAs calculated using only standardised approaches (SAs) (where the latter is called 'the output floor' or 'floored RWAs');
- to apply the requirement to UK firms that are not part of a group headquartered overseas. For those firms, the output floor would be applied on a consolidated basis at the level of the UK consolidation group where such a group exists, or on an individual basis where the firm is not part of a group. In addition, where a firm is a ring-fenced body (RFB), the output floor would be applied on a consolidated basis at the level of the ring-fenced sub-group, or on an individual basis where the RFB is not part of a ring-fenced sub-group;
- to require those firms to apply floored RWAs in the calculation of all own funds requirements and buffers when becoming bound by the output floor;
- to require that IM firms apply the PRA's proposed implementation of the SA in the same manner as for firms without permission to use IMs; and
- to apply the transitional arrangements for the output floor, consistent with the Basel 3.1 standards regarding the length of transition period, beginning on 1 January 2025.

9.4 The PRA allows firms to measure risk and calculate associated RWAs in two different ways, depending on the risk concerned: the SAs, in which the PRA determines the risk weights that should be applied to different exposures and risks; and IM approaches, where the PRA allows firms with the requisite permissions to model certain parameters. The output floor, a central new element in the Basel 3.1 standards, aims to ensure that RWAs for firms with IM permissions do not fall below a defined percentage of the RWAs calculated under the SAs. The output floor is intended to promote the safety and soundness of firms with IM permissions, and to facilitate competition between SA and IM firms.

9.5 The Basel Committee on Banking Supervision (BCBS) has noted concerns with the excessive variability and lack of comparability of modelled risk weights, and stated an intention to restore the credibility of the risk-weighted regulatory capital framework by constraining the RWA impact of IM approaches. The BCBS has indicated specific concern that IM approaches, at an aggregate level, fail to adequately capture relevant risks. This is because the modelling of relatively rare events is often uncertain, and so the output floor imposes a 'backstop' to guard against risk weights falling excessively low, as well as guarding against excessive variability in risk weights. The PRA shares these concerns.

9.6 The proposals set out in this chapter regarding the output floor requirements are relevant to UK-headquartered groups that are within scope of the proposals in this CP (see Chapter 2 – Scope and levels of application).[1] In addition, the section below on 'Output floor – scope and levels of application' is also relevant to UK-based subsidiaries of foreign firms with permission to use IM approaches, which the PRA does not propose to include in the output floor requirement, but which may be subject to ad hoc data requests.

Implementation of an output floor

9.7 In line with the Basel 3.1 standards, the PRA proposes to implement an output floor. The proposed output floor would aim to address identified shortcomings in the use of IMs, and support the restoration of credibility in the risk-weighted regulatory capital framework. The PRA considers this proposal critical to the overall implementation of the Basel 3.1 standards, as it complements and supports refinements to the SA and IM regimes, and promotes the enhancement of risk-sensitivity.

9.8 The PRA proposes that a firm within the scope of the output floor would be required to calculate RWAs, for the purposes of compliance with own funds requirements and buffers, as the higher of: (i) the total RWAs calculated using all approaches which it has supervisory approval to use (including IM approaches); or (ii) 72.5% of RWAs calculated using only standardised approaches, using the following calculation: [2]

$$\boldsymbol{Total\ RWA} = \mathbf{max}\,\{\boldsymbol{RWAs(all\ approaches), 0.725 * RWAs(SA\ only)}\}$$

9.9 The PRA's proposals for the scope and levels of application of the proposed output floor, as well as the SAs required and the proposed five-year transition period, are addressed in more detail later in this chapter.

PRA objectives analysis

9.10 The PRA considers that the proposed output floor would reduce excessive cyclicality in RWAs, enhance comparability of RWAs among firms, and protect against model risk, promoting the credibility of the risk-weighted regulatory capital framework. The PRA also considers that the proposed output floor would reduce undercapitalisation due to uncaptured model risk. By implementing an output floor, the PRA aims to promote safety and soundness by providing a robust and transparent backstop to the use of IM approaches, addressing concerns shared by the BCBS and the PRA (see cost benefit analysis section of Chapter 1 – Overview, and Appendix 7).

9.11 In addition, IM approaches often generate significantly lower risk weights than the SAs for similar exposures. The PRA considers that the proposed output floor, by applying the same SA methodologies to SA and IM firms, would support competition by narrowing and stabilising the gap in risk weights between them.

'Have regards' analysis

9.12 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. The PRA has also taken into consideration the matters for which it is required to when proposing changes to CRR rules (as defined in section 144A of FSMA). The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Proportionality (FSMA regulatory principles):

- The PRA considers that the proposed output floor represents a proportionate response to shortcomings in IM approaches. The proposal would most directly impact firms with IM permissions, which are typically larger and more complex.
- The PRA considers that the 72.5% multiplier would allow the output floor to function as a supportive backstop, without removing incentives to pursue IM approval.

2. Finance to the real economy (FSMA CRR rules) and sustainable growth (FSMA regulatory principles and HMT recommendation letter):

- By improving the credibility of the risk-weighted regulatory capital framework, the PRA considers that the proposed output floor would support the UK's position as a global financial centre, in turn supporting the provision of finance to the real economy. The PRA also considers that the proposal would support the sustainable provision of finance to the real economy by introducing a backstop against model risk, supporting financial stability in the case of unanticipated and extreme market outcomes.

- By reducing the cyclicality of RWAs, the PRA considers that the proposed output floor would promote smoother lending throughout the business cycle and potentially reduce buffer requirements, also supporting sustainable growth.

3. Relevant international standards (FSMA CRR rules):

- The proposed output floor, including the use of the 72.5% multiplier, aligns with the Basel 3.1 standards.

4. Relative standing of the UK as a place to operate (FSMA CRR rules) and competitiveness (HMT recommendation letter):

- The proposed implementation of the output floor, and alignment with the 72.5% multiplier, aligns with the phased-in implementation of the Basel 3.1 standards proposed by regulators in other jurisdictions. Some international peers have proposed to alter the SA methodologies on a transitional basis for the purposes of the calculation of the output floor,[3] effectively creating an alternative set of SAs and reducing the overall estimated impact of the output floor. However, the PRA considers that implementing a common and consistent SAs framework for all firms would best promote safety and soundness and the competition benefits of the output floor. By responding appropriately to identified gaps in risk capture, the PRA considers that the proposed output floor would promote competitiveness by supporting the international reputation of the UK.

Scope and levels of application

9.13 The output floor within the Basel 3.1 standards is intended to apply to ‘internationally-active banks’ that use IMs, including to relevant entities within their groups. The output floor primarily aims to address issues of cyclicality, accuracy, and consistency in RWAs at a broad level rather than activity by activity. Therefore, the PRA considers that the proposed output floor would perform its intended functions most effectively and proportionately as a consolidation level measure.

9.14 The PRA also considers the output floor an aggregate measure most effectively applied at the consolidated level, to allow the recognition of diversification between risks and reduce the potential impact on specific business activities. The PRA considers that application at the consolidation level would protect against disproportionate impacts for more specialist entities.

9.15 The proposed output floor would apply to firms in scope of the PRA’s CRR requirements in the following way:

- on a consolidated basis only, at the UK consolidation level (ie the ultimate UK group level) of UK-headquartered groups;
- on an individual basis to UK stand-alone firms; and

- on a sub-consolidated basis for RFB sub-groups, or individual basis where the RFB is not part of a ring-fenced sub-group.

9.16 The PRA proposes to apply the output floor to all UK-headquartered groups within the scope of the PRA's CRR requirements. The PRA proposes to exclude UK-based subsidiaries of banking groups headquartered overseas ('international subsidiaries') that are subject to group consolidation outside the UK. The PRA expects that the floor would be applied to the overseas group or parent company on a consolidation level in its home jurisdiction.

9.17 The PRA may consider extending the output floor requirement to such international subsidiaries if it considers there to be a prudential case to do so (eg if the floor is not implemented, or not implemented in line with international standards, in home jurisdictions). In support of this, the PRA may request international subsidiaries with approval to use an IM to provide data on an ad hoc basis to support the PRA's understanding of the potential impact of application of the floor. This is set out in more detail below (see paragraphs 9.21 – 9.23).

9.18 For RFBs, the PRA proposes to implement the output floor both at the UK consolidation level and at the level of the ring-fenced sub-group (or individual RFB if there is no sub-group). This reflects the prudential function of the ring-fence (ie treating the ring-fenced sub-group as equivalent to the UK consolidation level, within the ring-fence).

9.19 The PRA considers that applying the output floor as set out above would allow firms to benefit from diversification within a group structure, while still being held to a robust and transparent backstop. Extending the floor to RFBs would be consistent with this approach, while also facilitating competition for firms concentrated in residential retail mortgages.

9.20 Proposed reporting requirements for firms within scope of the output floor are covered in Chapter 12 – Reporting.

Data gathering for IM firms excluded from scope

9.21 The PRA does not propose to introduce a requirement for international subsidiaries that are excluded from the scope of application of the output floor (as set out above) to provide data on a regular basis. However, the PRA may request firms excluded from the scope of the PRA's output floor to participate in ad hoc data gathering exercise(s) on the impact of the output floor, including international subsidiaries.

9.22 The PRA considers that using ad hoc exercise(s) would allow required on-going impact assessment of the proposed scope and levels of application of the output floor to be carried out in a proportionate way. This analysis would also support the PRA in any potential adjustment of the scope of the output floor in the future, subject to further consultation.

9.23 The PRA would ask IM firms not subject to the output floor to participate in any ad hoc exercises to the fullness of their capacity, and provide high-quality data. If responses of an insufficient quantity or quality were received, the PRA would consider the extension of the requirements set out in Chapter 12 to firms otherwise not subject to the output floor. This would reflect the fact that a minimum level of information would be required by the PRA in order to quantitatively assess and justify its decision to exclude these firms from the scope of the floor, where they are otherwise subject to PRA requirements for IM firms.

PRA objectives analysis

9.24 The PRA considers that the consolidation level (including the RFB sub-group level as per paragraph 9.18) is the most appropriate basis on which to apply the output floor as a prudential backstop, advancing the safety and soundness of firms by addressing a gap in risk capture, while continuing to support specialisation within well-diversified groups.

9.25 With regards to the secondary competition objective, the PRA's proposal aims to facilitate competition between subsidiaries by applying the output floor consistently at the consolidation level only. By extending the scope of the floor to the consolidation level for RFBs, the proposal also aims to treat RFBs consistently with the intentions of the ring-fence requirements by treating RFBs as independent of their wider consolidated groups, while also supporting a level playing field in the provision of finance by firms to the UK domestic retail market.

'Have regards' analysis

9.26 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. The PRA has also taken into consideration the matters for which it is required to when proposing changes to CRR rules (as defined in section 144A of FSMA). The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Proportionality (FSMA regulatory principles):

- As the output floor is an aggregate measure, the PRA considers it most proportionate to propose application at the consolidated level, where diversification can be taken appropriately into account and excessive impact on more specialised subsidiaries avoided.
- The PRA considers that applying the floor at the RFB level aligns with this approach and the intentions of the ring-fencing regime, as it treats RFBs as independent of their wider consolidated groups.

- The proposed scope and levels of application would balance these concerns with the need to provide a robust and consistent backstop against model risk.

2. Sustainable growth (FSMA regulatory principles and HMT recommendation letter) and finance to the real economy (FSMA CRR rules):

- The PRA considers that the proposed scope and levels of application of the output floor would contribute towards sustainable growth and the sustainable provision of finance to the real economy by ensuring IM firms are adequately capitalised against model risk, avoiding as far as possible imposing costs directly on specialised subsidiaries or business lines.
- The PRA also considers that the proposed scope and levels of application would support sustainable growth by reducing the cyclicality of risk weights for UK headquartered firms at the aggregate level, while not restricting more specialised business models within diversified groups.

3. Relevant international standards (FSMA CRR rules):

- The PRA considers that the proposed scope and levels of application are broadly aligned with international standards, by ensuring that 'internationally active banks' are subject to the output floor on a consolidated basis.

4. Relative standing of the UK as a place to operate (FSMA CRR rules) and competitiveness (HMT recommendation letter):

- The PRA considers that the proposed scope and levels of application would support competitiveness by promoting regulatory consistency and the ease of doing business across borders. By proposing not to apply the output floor directly to either international or domestic subsidiaries, where they are similarly subject to group consolidation and supervision for the purposes of the application of the output floor, the PRA considers the proposal would be supportive of the competitiveness of the UK as a place to do business.

5. Mutuals (FSMA obligation):

- The PRA considers that mutuals with IM permissions may experience a relatively higher impact from the output floor, to the extent that internal ratings based (IRB) approaches continue to produce lower average risk weights relative to the SA, following the proposed changes to Supervisory Statement (SS) 11/13 – **'Internal Ratings Based (IRB) approaches'** set out Policy Statement (PS) 13/17 – **'Residential mortgage risk weights'**, PS11/20 – **'Credit risk: Probability of Default and Loss Given Default estimation'**,[4] and the proposed implementation of the Basel 3.1 standards.

- The PRA has considered this impact, and reached the view that a prudential case nonetheless exists to apply the output floor to mutuals, in line with the proposed approach to IM groups and RFBs. While mutuals may be more impacted by the proposed floor due to operating with legal constraints on their capacity to diversify, the PRA considers that this does not reduce their exposure to model risk, which may be amplified by specialisation in residential retail mortgages, and less diversified model use. The PRA considers that the impact of the output floor on mutuals may also be smaller when considered alongside the combined impact of other elements of the capital framework eg firm-specific buffers (see Chapter 10 – Interactions with the PRA's Pillar 2 framework).
- From the perspective of competition, the PRA also considers that this approach would result in mutuals being treated consistently with RFBs, which are similarly concentrated in residential retail mortgage lending.
- However, in recognition of the constraints on the business models of mutuals and the potential high impact due to their concentration in residential retail mortgages, the PRA welcomes specific responses from mutuals on the impact of the output floor as proposed.

Question 49: Do you support the scope and levels of application of the PRA's proposed output floor? Do you have any additional evidence on the potential impact of these proposals with respect to different activities or particular business lines?

Application of the output floor to minimum requirements and buffers

9.27 As set out in the PRA Rulebook and SS16/16 – '**The minimum requirement for own funds and eligible liabilities (MREL) – buffers and Threshold Conditions'**, firms must meet the following own funds requirements at all times:

- Common Equity Tier 1 (CET1) must be at least 4.5% of RWAs;
- Tier 1 capital must be at least 6.0% of RWAs;
- Total capital (Tier 1 capital and Tier 2 capital) must be at least 8.0% of RWAs;
- where relevant, firm-specific Pillar 2A; and
- where relevant, minimum requirement for own funds and eligible liabilities (MREL).

9.28 In addition to the regulatory minima set out above, firms are expected[5] to also meet all relevant buffers, including:

- the capital conservation buffer (CCoB), set at 2.5% of RWAs, and countercyclical capital buffer (CCyB)[6] when relevant;
- higher loss absorbency requirements for systemic firms, ie for firms identified as global systemically important banks (G-SIBs) or other systemically important institutions (O-SIIs); and

- the PRA buffer (also referred to as Pillar 2B), where relevant.

9.29 The PRA proposes that when the output floor is 'activated' (ie when 72.5% of RWAs calculated using SAs exceed RWAs calculated using IM approaches), 'floored' RWAs would be used as the applicable RWAs wherever relevant in all elements of the capital stack, including the requirements set out above.

9.30 Firms within scope of the leverage ratio framework would also remain subject to leverage ratio requirements.

9.31 The PRA has considered the possibility of double-counting in developing this proposal, and considers that no material methodological overlap would exist between the proposed output floor and the PRA's Pillar 2 methodologies. While Pillar 2 covers a range of risks not addressed under Pillar 1, model risk is not captured specifically. As set out in Chapter 10, to the extent that the proposals in this CP would as a whole improve risk capture in Pillar 1, Pillar 2A capital requirements would be revised to account for duplication of risk capture.

9.32 However, the PRA considers that the interaction between the output floor and the own funds requirements and buffers set out above may be complex, as explained in more detail in Chapter 10. The PRA would monitor the interactions between the output floor, Pillar 2A, and the capital buffer framework, and provide additional guidance on appropriate methodologies and calculations should it consider this necessary. The PRA welcomes responses, including evidence, regarding the impact of these issues, and regarding where additional guidance on potential interactions would support implementation.

PRA objectives analysis

9.33 In light of the PRA's support for the prudential purposes of the output floor, the PRA considers that the application of floored RWAs through the whole capital stack would be the most consistent, conceptually sound, and simple approach to implementing the output floor. The proposed approach minimises the potential for undercapitalisation due to uncaptured model risk, advancing the PRA's objective of safety and soundness.

9.34 By ensuring G-SIBs' and O-SIIs' buffer requirements reflect the output floor, supporting the comprehensibility and comparability of total RWAs across firms and closing the gap between SA and IM firms, the proposed approach would advance the PRA's secondary competition objective.

'Have regards' analysis

9.35 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April

2022. The PRA has also taken into consideration the matters for which it is required to when proposing changes to CRR rules (as defined in section 144A of FSMA). The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Proportionality (FSMA regulatory principles):

- The PRA considers that the proposed application of floored RWAs for the purposes of meeting all regulatory minima and relevant buffers represents the most proportionate approach to implementation of the output floor. This aims to ensure consistency in calculations and limits the complexity of the capital stack, as well as appropriately managing the potential impact of model risk. The PRA has considered the possibility of double-counting, and does not consider that double-counting would arise as a result of this proposal.

2. Sustainable growth (FSMA regulatory principles and HMT recommendation letter) and finance to the real economy (FSMA CRR rules):

- The PRA considers that the proposed approach would support sustainable growth and provision of finance to the real economy by ensuring risk-sensitive adjustments to risk-weighting methodologies are reflected wherever total RWAs are used. The PRA considers this would address shortcomings in the existing framework and reduce cyclicality, promoting sustainable lending to the real economy through the cycle.

3. Relative standing of the UK as a place to operate (FSMA CRR rules) and competitiveness (HMT recommendation letter):

- The proposed approach of applying floored RWAs for the calculation of own funds requirements and buffers is materially aligned with the proposals set out by international peers, and therefore supports the UK's attractiveness as a place to do business. Jurisdictions that consider their approach to Pillar 2A may capture firm-specific model risk (such as the EU) have proposed to review approaches to additional own funds requirements on a firm-by-firm basis at the point when a firm is bound by the floor. The PRA does not address model risk in its Pillar 2A methodologies, but nevertheless would consider any potential interaction between the output floor and its approach to Pillar 2 through its upcoming review of Pillar 2A (to be completed by 2024).

4. Relevant international standards (FSMA CRR rules):

- The proposed approach of applying floored RWAs for the calculation of own funds requirements and buffers aligns with the proposals set out by the Basel 3.1 standards, and would promote enhanced risk-sensitivity in requirements for international firms subject to relevant buffers (ie G-SIBs).

Question 50: Do you have any comments on the PRA's proposal that when the output floor is activated, 'floored' RWAs should be used wherever relevant in all elements of the capital stack? Do you have any additional evidence that is relevant to this proposal to inform the PRA's analysis?

Standardised approach methodologies used in the calculation of the output floor

9.36 The PRA considers that a robust and consistent application of SA methodologies by IM firms subject to the floor is necessary to achieve the prudential objectives of the output floor. The PRA considers this is appropriate given the PRA's proposals would enhance risk-sensitivity in the SA. The PRA proposes that when applying the output floor, IM firms would apply the PRA's proposed implementation of the SA, in the same manner as for firms without permission to use IM.

9.37 The PRA proposes to implement the following SA methodologies:

- **credit risk**: the SA for credit risk (see Chapter 3 – Credit risk – Standardised approach, and Chapter 5 – Credit risk mitigation). Credit risk mitigation (CRM) eligibility requirements and techniques that are only available under Foundation IRB or Advanced IRB, and not under the SA, would not be used for the purposes of the output floor;
- **counterparty credit risk**: when calculating the exposure for derivatives, firms would use the SA for counterparty credit risk (SA-CCR) as set out in the Counterparty Credit Risk Part, subject to the proposed adjustment to those rules set out in Chapter 7 – Credit valuation adjustment and counterparty credit risk. This approach would be combined with the relevant borrower risk weights from the SA for credit risk (as proposed in Chapter 3);
- **credit valuation adjustment (CVA) risk**: the SA for CVA (SA-CVA), the Basic Approach for CVA (BA-CVA), or 100% of the counterparty credit risk capital requirements ('AA-CVA'), as set out in Chapter 7, depending on which of these approaches is used by the firm for CVA risk;
- **securitisation**: the external ratings-based approach (SEC-ERBA), the SA (SEC-SA), or a risk weight of 1250% as set out in the CRR, as applied by Article 92 of the Required Level of Own Funds (CRR) Part for the purposes of the output floor. The SAs for securitisation are an area the PRA intends to keep under review and may consult on separately in due course (see Box 1 below);
- **market risk**: the SA for market risk (see Chapter 6 – Market risk), using the approaches for securitisations set out above when determining the default risk charge component for securitisations held in the trading book; and

- **operational risk, settlement risk, dilution risk, market risk for items in the non-trading book and requirements for large exposures:** the relevant SA, as per part 3 of Article 92 of the Required Level of Own Funds (CRR) Part.

Box A: Output floor application to securitisation exposures

1. Consistent with the PRA's proposals set out in this chapter and the Basel 3.1 standards, firms would be required to use the SEC-ERBA, the SEC-SA, or a risk weight of 1250% when calculating RWAs for the purposes of the output floor as set out in the CRR, as applied by Article 92 of the Required Level of Own Funds (CRR) Part. In 2021, respondents to HMT's Call for Evidence on Securitisation Regulation highlighted concerns regarding the potential impact of the output floor on RWAs for certain types of securitisations. The PRA has considered the feedback provided, including the illustrative examples indicating a potentially material increase in RWAs for positions in certain types of significant risk transfer (SRT) securitisations.

2. The PRA proposes that securitisation exposures, including retained tranches of SRT securitisations, are included in the output floor calculation, in line with the Basel 3.1 standards. As the PRA proposes to apply the output floor at the UK consolidation level, and on a sub-consolidated basis for RFB sub-groups, the PRA considers that the output floor would not directly affect securitisation exposure-level RWAs or securitisation transaction-level supervisory assessments. For example, the output floor would not directly affect the supervisory assessment of commensurate risk transfer under CRR Articles 244 and 245, the calculation of maximum risk weights and RWAs in Articles 267 and 268, nor the PRA's expectations in relation to the thickness of sold or protected tranches for portfolios of SA exposures.

3. However, the PRA proposes to engage with firms originating SRT securitisations, including during the output floor transition period, to understand the impact of the proposed use of standardised methodologies for securitisations for the purposes of the output floor. The PRA also proposes to engage with market participants with regards to the risk-sensitivity of the SEC-SA relative to the SEC-IRBA, and how the use of the SEC-SA in the output floor calculation may impact the origination of SRT. The PRA may consider carrying out a further consultation to address any issues identified, and would aim to do so during the output floor transition period.

PRA objectives analysis

9.38 The PRA considers that the proposed approach would support the safety and soundness of firms by ensuring that the output floor is a consistent and transparent backstop to modelled risk weights.

9.39 The proposed approach would also support the PRA's secondary competition objective by holding IM firms to a consistent standard in the application of the SA methodologies, enhancing comparability and levelling the playing field between SA and IM firms.

'Have regards' analysis

9.40 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. The PRA has also taken into consideration the matters for which it is required to when proposing changes to CRR rules (as defined in section 144A of FSMA). The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Finance to the real economy (FSMA CRR rules) and sustainable growth (FSMA regulatory principles and HMT recommendation letter):

- The PRA considers the proposed approach to SA methodologies for the calculation of the output floor would provide the most robust and transparent backstop, ensuring the risk-weighting framework would appropriately capture the true risks faced by firms, and so enabling them to support sustainable growth in the long-term. This would be supported by the revisions to the SAs proposed elsewhere in this CP, which aim to improve risk-sensitivity.
- The PRA also considers that applying the SA methodologies faithfully would reduce the pro-cyclicality of risk weights for IM firms, which would better enable firms to provide finance to the real economy through the cycle and therefore support stable and sustainable growth.

2. Relative standing of the UK as a place to operate (FSMA CRR rules) and competitiveness (HMT recommendation letter):

- The PRA considers that by aligning with the end state approaches proposed by international peers,[7] the proposed application of the output floor supports the competitiveness of the UK. As noted above, the PRA considers that implementing a common and consistent application of the SAs would most effectively promote the safety and soundness and competition benefits of the output floor, ultimately benefiting the competitiveness of the UK by supporting the international reputation of the UK and its regulatory authorities.

- To the extent that any of the PRA's proposals with regards to the SA calculations affect competitiveness, these are considered in the relevant risk chapters (eg information regarding the proposed SA to unrated corporates may be found in Chapter 3).
- With regards to the PRA's proposal to implement the output floor for securitisations, the PRA is aligned with the Basel 3.1 standards and the European Commission's October 2021 proposals, but would continue to monitor approaches in other international jurisdictions and would take into account competitiveness in finalising the proposals set out in this CP.

3. Proportionality (FSMA regulatory principles):

- The PRA considers that consistent application of the SAs for the implementation of the output floor is proportionate as this would limit potential complexity by avoiding the introduction of an additional methodology for the calculation of risk weights specific to the floor.

Transition period

9.41 The PRA proposes to apply the transitional arrangements for the output floor, aligning with the Basel 3.1 standards regarding the length of the proposed transition period. This transition period would begin on 1 January 2025, in line with the PRA's proposed overall implementation date (see Chapter 1 – Overview). The transition period is intended to support the implementation of the floor in an orderly manner, and reduce potential cliff edges in own funds requirements.

9.42 For the purposes of the transition period, the output floor would be calibrated as set out below:

$$\max\{RWAs(all\ approaches), X * RWAs(SA\ only)\}$$

$$X = \textit{transitional multiplier}$$

Multipliers for the output floor

	Date[8]	Multiplier
Transitional	1 January 2025	50%
	1 January 2026	55%
	1 January 2027	60%
	1 January 2028	65%
	1 January 2029	70%
End-state	1 January 2030	72.5%

9.43 The PRA does not propose to implement the transitional cap, a national discretion given in the Basel 3.1 standards whereby jurisdictions may cap the incremental increase in RWAs as a result of application of the output floor at 25% for the duration of the transition period. While it may provide some relief from the impact of the floor for the purposes of the transition period for any firm substantially impacted, the PRA considers that the cap would create a cliff-edge when removed, by introducing additional volatility in the short- to medium-run, undermining the benefits of the output floor to safety and soundness.

PRA objectives analysis

9.44 The PRA considers that implementing the full transition period, without a transitional cap, would support the safety and soundness of firms by reducing potential cliff-edges in own funds requirements, and allow firms to adjust to changes in own funds requirements in an orderly manner.

9.45 The PRA also considers that implementing the full transition period would facilitate competition by ensuring that all firms have sufficient time to implement the output floor in an orderly manner, in particular those facing a higher fully phased-in impact from the floor.

'Have regards' analysis

9.46 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. The PRA has also taken into consideration the matters for which it is required to when proposing changes to CRR rules (as defined in section 144A of FSMA). The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Proportionality (FSMA regulatory principles) and finance to the real economy (FSMA CRR rules):

- The PRA considers that the proposal to implement the full transition period is proportionate and consistent with the proposals set out in this chapter, as it aims to allow firms sufficient time to adjust to any changes in own funds associated with the output floor. In this way, the PRA considers that an orderly transition over a long transition period would support the provision of sustainable finance to the real economy. The PRA considers its proposal not to implement the RWA cap proportionate, given the potential risk of cliff-edges in own funds requirements and ratios.

2. Relative standing of the UK as a place to operate (FSMA CRR rules) and competitiveness (HMT recommendation letter):

- The proposed approach aligns with the overall timeline of other jurisdictions, based on the PRA's current understanding of such timelines.
- In light of its objectives and other have regards, the PRA has considered the potential impact of implementing transitional adjustments to the calibration of SA methodologies used for the calculation of the output floor as proposed in other jurisdictions. While there may be a short-term competitiveness impact to not aligning with other jurisdictions during the transition period, implementing the full transition period is the PRA's preferred approach to supporting firms in adjusting to any changes in own funds requirements that may arise from the proposed output floor, due to concerns regarding introducing alternative SA methodologies set out above. The PRA considers that its proposed approach would best advance the PRA's objectives, while ensuring relative consistency over time and reduces the risk of cliff-edges in methodologies or own funds requirements.
- The PRA has also considered competitiveness in the calibration of SAs at the asset class level, and this analysis may be found in the relevant chapters.

3. Mutuals (FSMA obligation):

- The PRA considers that the proposed approach would support mutuals with IM permissions, which may face higher impacts due to constraints on their capacity to diversify at the consolidation level (as set out above), to adjust to and implement the output floor without disrupting their routine business.

> **Question 51: Do you have any comments on the PRA's proposed transitional arrangements including the proposal to not apply the discretionary transitional cap?**

1. The proposals will not apply to UK banks and building societies that meet the Simpler-regime criteria and choose to be subject to the Transitional Capital Regime proposals.
2. The PRA does not propose any adjustments to the treatment of accounting provisions. Firms that use IM approaches would not be required to make any adjustments to the treatment of accounting provisions with respect to own funds to align with SAs, regardless of whether they are bound by the output floor.
3. For example, the **European Commission's proposal**.
4. The PRA does anticipate that the impact of the floor would be negated by the leverage ratio, in cases where mutuals remain or become leverage constrained.
5. As set out in the PRA Rulebook (Capital Buffers), Supervisory Statement 6/14 – '**Implementing CRD IV: capital buffers'**, December 2020, and the Statement of Policy – '**The PRA's methodologies for setting Pillar 2 capital'**, July 2021.
6. The PRA does not propose any change to the calculation of institution-specific CCyB rates. This means that regardless of whether the output floor is 'activated', firms would continue to use relevant credit exposures, using models where they have permission, when calculating the weighted average of the CCyB rates that apply to exposures in the jurisdictions where firms' relevant credit exposures are located. The PRA will keep this under review.
7. As noted earlier in the chapter, the European Commission have proposed alterations to the standardised methodologies on a transitional basis for the purposes of the calculation of the output floor.
8. Based on the proposed 1 January 2025 starting implementation date for the proposals set out in this CP.

Appendices

Appendix 4: Draft PRA Rulebook (CRR) Instrument [2023] (PDF 4.1MB)

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CP16/22 – Implementation of the Basel 3.1 standards: Interactions with the PRA's Pillar 2 framework

Chapter 10 of CP16/22

Published on 30 November 2022

Content

Overview

10.1 This chapter describes, at a high level, the implications of the proposed changes to the Pillar 1 risk-weighting framework, as set out in this Consultation Paper (CP), for the Prudential Regulation Authority's (PRA) Pillar 2 framework. The PRA's Pillar 2 framework consists of two distinct variable components: Pillar 2A and Pillar 2B. Pillar 2A is a firm-specific minimum capital requirement that covers a range of risks not addressed under Pillar 1 (eg credit concentration risk, and interest rate risk in the banking book), or not adequately addressed by the Pillar 1 framework. Pillar 2B, also known as the PRA buffer, is an amount of capital firms should maintain in addition to their total capital requirements and the combined buffer to absorb the losses that may arise in a severe, but plausible, stress scenario. The PRA's methodologies for setting Pillar 2 capital requirements are set out in full in PRA Statement of Policy – **'The PRA's methodologies for setting Pillar 2 capital'** ('Pillar 2 SoP').

10.2 This chapter does not contain any specific new policy proposals. The PRA intends to review its Pillar 2A methodologies more fully by 2024, so that Pillar 2 requirements and any corresponding reporting requirements are updated as necessary before the changes to the Pillar 1 framework set out in this CP are implemented. However, this chapter sets out a range of topics the PRA is currently considering. By doing so, the PRA is intending to: give firms additional clarity on how it intends the overall going-concern capital framework to operate; flag Pillar 2 policy areas that would need further development; and give firms an opportunity to raise any additional concerns and provide any feedback at this stage. The topics included in this chapter are:

- how Pillar 2A operational risk, market risk and credit risk methodologies, set out in full in the Pillar 2 SoP interact at a high level with the proposed changes to Pillar 1 risk-weighted asset (RWA) approaches set out within this CP;
- at a high level, the consequential impacts to capital buffers including the PRA buffer; and
- the timing and setting of firm-specific capital requirements.

10.3 The PRA considers the proposed improvements to the measurement of the Pillar 1 risk weights and the introduction of the output floor to generally complement its existing Pillar 2 framework. However, it recognises the interactions can be complex. As a principle, the PRA would not double count capital requirements for the same risks in Pillar 1 and Pillar 2A. This means that, to the extent that the proposals set out in this CP improve risk-capture in Pillar 1, the Pillar 2A capital requirements would be adjusted accordingly. The PRA's existing Pillar 2A framework adjusts mechanically in some areas, such as operational risk, however, others would require policy changes.

10.4 This chapter is relevant to PRA-authorised banks, building societies, PRA-designated investment firms, and PRA-approved or PRA-designated financial holding companies or mixed financial holding companies ('firms'). For firms in scope of the strong and simple framework (see Chapter 1 – Overview and Chapter 2 – Scope and levels of application), future policy proposals that simplify the framework may have further implications.[1]

Pillar 2A – Operational risk

10.5 The PRA's methodology for setting Pillar 2A capital requirements for operational risk is set out in the Pillar 2 SoP. As set out in the SoP, operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, and includes legal risk. The PRA's existing Pillar 1 standardised approach for operational risk uses gross income as a measure of risk. This is not risk-sensitive. The PRA therefore assesses operational risk as part of its Pillar 2A review of firms' capital adequacy and, where appropriate, applies a Pillar 2A capital add-on.

10.6 In summary, the PRA undertakes an overall assessment of a firm's operational risk informed by, among other factors, historical losses, a firm's Internal Capital Adequacy Assessment Process (ICAAP), and conduct and non-conduct loss estimates. From that overall assessment, supervisory judgement is used to determine a firm-specific operational risk capital requirement.

10.7 The PRA's proposals to implement the new operational risk standardised approach (SA), set out in the Basel 3.1 standards, is outlined in Chapter 8 – Operational risk. For some firms, moving to the SA may result in an increase in Pillar 1 RWAs for operational risk. The PRA's Pillar 2A methodology for setting any operational risk add-ons already takes into account Pillar 1 operational risk RWAs. All else being equal, the PRA considers most firms' total Pillar 1 and Pillar 2A operational risk capital requirements would remain unchanged, so any Pillar 2A add-on would be reduced in line with any Pillar 1 RWA increase. The PRA also considers the inverse to hold true: should a firm's Pillar 1 RWAs for operational risk fall as a result of moving to the SA, all else being equal, any Pillar 2A add-on would consequently increase. Departures from this result may however occur for individual firms, consistent with the overarching objective that firms should have sufficient capital for the operational risks to which they are exposed.

10.8 The PRA does not, therefore, intend to make significant changes to its Pillar 2A methodology for operational risk as a consequence of the changes in the Pillar 1 framework at present. But there may be some areas that could benefit from further clarification or changes to ensure the methodology remains consistent with the Pillar 1 operational risk proposals set out in this CP (eg updating references to Pillar 1 operational risk approaches in line with the proposals set out in this CP if adopted). These would be considered as part of the PRA's Pillar 2A review.

Pillar 2A – Market risk

10.9 The PRA's methodology for setting Pillar 2A capital requirements for market risk is set out in full in the Pillar 2 SoP. As set out in the SoP, market risk is the risk of losses resulting from adverse changes in the value of positions arising from movements in market prices across commodity, credit, equity, foreign exchange, and interest rates risk factors. Under the existing Pillar 2A methodology for market risk, the PRA may require firms to maintain additional capital under Pillar 2A to cover risks likely to be underestimated or not covered under Pillar 1. The majority of such risks relate to illiquid, one-way, and concentrated positions (referred to collectively as 'illiquid risks').

10.10 To inform the setting of Pillar 2A capital, the PRA relies on a firm's own methodologies for assessing illiquid and concentrated positions. This is because market risk is specific to firms' individual positions. The PRA's focus is on the quality of firms' methodologies, including the magnitude of market shocks applied to assess illiquidity risks. The PRA also assesses the firm's abilities to manage the risk.

10.11 As set out in Chapter 6 – Market risk, the PRA proposes significant changes to the Pillar 1 market risk framework. Overall, those changes would improve the existing market risk framework by ensuring market risk capital requirements are more commensurate with the risks faced by firms, most notably in the context of illiquid risks by increasing the time horizon for less liquid risk factor types to beyond 10 days.

10.12 The Pillar 2A capital add-on for illiquid risks is set such that the sum of Pillar 1 and Pillar 2A capital requirements would be sufficient to cover losses at a 99.9% confidence level. In line with the existing methodology set out in the Pillar 2 SoP, the PRA would reduce Pillar 2A capital add-ons if appropriate to reflect the extent that illiquid risks are partially captured in the proposed Pillar 1 framework for market risk.

10.13 While illiquidity risk capture would improve significantly under the new approach set out in this CP, the Pillar 1 capital requirements cannot be designed to capture every possible risk profile. Some market risks would likely remain underestimated or not covered in Pillar 1. The PRA's Pillar 2A framework also captures more extreme price movements. The PRA considers its existing Pillar 2A framework is sufficiently flexible to identify, and where necessary, capitalise, such risks, notwithstanding changes in the Pillar 1 approach.

10.14 The PRA is therefore not considering significant changes at the moment to its Pillar 2A methodology for market risk as a consequence of the proposed changes to the Pillar 1 framework, as set out in this CP.

Pillar 2A – Credit risk

10.15 The PRA's methodology for setting Pillar 2A credit risk add-ons is set out in full in the Pillar 2 SoP. As set out in the SoP, credit risk is the risk of losses arising from a borrower or counterparty failing to meet its obligations as they fall due. The PRA considers that there are asset classes for which the existing Pillar 1 credit risk standardised approach (SA) underestimates risk. The PRA therefore assesses credit risk as part of its Pillar 2 review of firms' capital adequacy, applying Pillar 2A add-ons in some instances.

10.16 The PRA has developed an internal ratings based (IRB) benchmark for different asset classes with which to compare SA credit risk weights. Where the IRB benchmark suggests that the SA risk weight for a particular portfolio is too low, additional capital may be required under Pillar 2A. Similarly, where the SA risk weight is too conservative for the risk, this is recognised when setting additional capital under Pillar 2A. Supervisory judgement is then used to determine whether any Pillar 2A credit risk add-ons are required, taking into account considerations such as firms' own assessments, the IRB benchmark range, the PRA's confidence in the benchmarks, and supervisory knowledge of the credit risk portfolios.

10.17 As set out in Chapter 3 – Credit risk - standardised approach, Chapter 4 – Credit risk - internal ratings based approach, and Chapter 5 – Credit risk mitigation, the PRA proposes significant changes to the Pillar 1 credit risk framework. Overall, those changes would improve risk capture, however, some deficiencies may remain. For example, as set out in Chapter 3, the PRA has concerns that some SA risk weights for central governments, central banks, regional governments and local authorities can continue to potentially result in underestimation of RWAs. Therefore, the PRA considers a Pillar 2A methodology for credit risk would likely continue to be required. The PRA does not propose any policy changes within this CP and intends to reflect further on its Pillar 2A methodology to credit risk as part of its Pillar 2A review. A number of areas that the PRA intends to consider in its review are discussed below, and the PRA welcomes feedback on these or other areas that may require consideration.

Use of IRB benchmarks

10.18 The use and reliance on the IRB benchmarks in the PRA's existing Pillar 2A methodology to credit risk would need to be reviewed as part of the PRA's Pillar 2A review. The IRB benchmarks are drawn from data the PRA has on the risk weights generated by firms' IRB models. There are two issues that need to be considered: (a) the proposals set out in this CP would likely change some of those models and associated risk weights, and (b) the proposals set out in this CP would require some exposures that can currently be modelled under IRB to be moved to SA, so there would no longer be IRB benchmarks on which to rely.

Interaction with the output floor

10.19 The output floor applies at a firm-wide level (or ring-fenced body), and not to individual asset classes, models or risk weights. But in instances where it is the binding RWA constraint on an IRB firm, that firm would have higher RWAs than its models alone suggest. The PRA intends to consider how, or if, this should be taken into account in any revised IRB benchmark and Pillar 2A add-on.

Refined methodology

10.20 The PRA's Pillar 2A credit risk methodology was updated in 2017, updating the Pillar 2 SoP and Supervisory Statement 31/15 – **'The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)**' as set out in Policy Statement (PS) 22/7 – **'Refining the PRA's Pillar 2A capital framework**', to allow some SA firms that meet specified criteria to compare their SA risk weights with those derived from typical IRB models. When making an overall assessment of the adequacy of their total capital requirements, the firm and the PRA can consider that comparison and assess whether there is any excess conservatism inherent in some aspects of the existing Pillar 1 SA.

10.21 For example, residential mortgages with a low loan to value (LTV) ratio attract a 35% risk weight in the existing framework. As set out in this CP, the PRA proposes to significantly reduce the SA risk weight, from 35% to 20%, for some residential mortgage exposures with LTV ratios of 50% or below. This would significantly reduce any higher degree of conservatism of the SA compared to IRB models for lower risk assets in this asset class.

10.22 The PRA will be considering whether it is appropriate to retain the existing refined methodology in its current form.

Combined buffer and Pillar 2B

10.23 In addition to Pillar 1 and Pillar 2A capital requirements, the PRA's capital framework includes a series of buffers. The capital conservation buffer (CCoB), which applies to all firms at all times, is set at 2.5% of a firm's RWAs. The countercyclical capital buffer (CCyB) also applies to all firms at all times. The CCyB rate is set by each national authority and applied to private sector credit exposures. The CCyB rate applied to UK exposures (the UK CCyB rate) is set by the Financial Policy Committee (FPC). The FPC has stated that it expects to set the level of the UK CCyB rate in the region of 2% in a standard risk environment.[2] Systemically important firms may have further buffers applied. Together, all of these buffers are sometimes referred to as the 'combined buffer'. The PRA also sets a firm-specific buffer referred to as the PRA buffer or Pillar 2B.[3]

10.24 This CP, consistent with the Basel 3.1 standards, does not contain any proposed changes to the combined buffer or the PRA buffer frameworks. However, the proposed changes to Pillar 1 risk weight methodologies and their cyclicality would have consequential effects to both buffer frameworks.

10.25 As required by the Capital Buffers (CRR) Part of the PRA Rulebook, firms must calculate the nominal amount of capital required to meet their combined buffer by multiplying their relevant buffer rates by Pillar 1 RWAs. Under the proposals set out in other chapters in this CP, many firms' Pillar 1 RWAs would change. Some firms' RWAs would increase, while some would decrease. The PRA considers such changes would be relatively modest (see aggregated cost benefit analysis in Chapter 1 and Appendix 7 - Aggregated cost benefit analysis). But any changes to the level of RWAs would, in turn, affect the nominal amounts of capital required to meet the combined buffers. The PRA considers such consequential changes in the size of the buffers in nominal terms to reflect the overall improved risk-sensitivity of the PRA's proposals.

10.26 The PRA buffer is set differently to the other buffers. Its size is informed by a range of factors including the results of relevant stress-testing and supervisory judgement.[4] It is generally calibrated to absorb losses that may arise under a severe stress scenario, while avoiding duplication with the combined buffer. To the extent that changes in Pillar 1 RWAs lead to nominal increases or decreases in a firm's combined buffer, the PRA buffer-setting policy already takes into account the quantum of capital calculated to meet the combined buffer.[5]

10.27 Moreover, the PRA anticipates the combined set of measures set out in this CP might lead to a decrease in the capital drawdown of some UK firms in a severe scenario. Therefore the total quantum of Pillar 2B buffer capital assessed through the stress impact set by the PRA may also decrease. The PRA recognises this is a complex area to assess. The PRA intends to keep its buffer-setting regime under review and intends to continue to exercise appropriate forward-looking supervisory judgement. The PRA welcomes any suggestions or reflections firms, and market participants may have in this area.

Timing implementation of firm-specific capital requirements

10.28 As set out earlier in this chapter, under the PRA's existing Pillar 2 framework, some potential changes in Pillar 1 RWAs as a result of the proposals set out in this CP are likely to be offset by corresponding adjustments in Pillar 2A add-ons (eg for operational risk). Potential changes in the quantum of capital calculated to meet the combined buffer may also lead to adjustments in the PRA buffer, all else being equal.

10.29 However, the Pillar 1 policy proposals (and thus RWA changes) set out in this CP are proposed to come into effect from the PRA's proposed implementation date of 1 January 2025 (see Chapter 1). Firm-specific Pillar 2A add-ons and PRA buffers typically change after a Supervisory Review and Evaluation Process (SREP), which happens once every 1-3 years depending on a firm's SREP cycle.

10.30 This could mean that either on the PRA's proposed implementation date of 1 January 2025 ('day 1') or during the phase-in of any transitional arrangements, Pillar 2A add-ons and PRA buffers would not be calibrated to firms' revised Pillar 1 RWAs, based on the implementation of the proposals set out in this CP, until a firm's next SREP cycle. In some instances, this may be immaterial. In others, it could result in disproportionately high capital requirements and buffers, or requirements and buffers that are too low to deliver on the PRA's primary objective of safety and soundness.

10.31 As part of the PRA's review of its Pillar 2A methodologies, the PRA intends to consider how to avoid gaps or duplications in the Pillar 1 and Pillar 2 capital frameworks on day 1 of the implementation of the proposals set out in this CP. The PRA welcomes any responses on these matters.

Interaction with the strong and simple framework

10.32 As set out in Chapter 1 and Chapter 2, the PRA proposes that firms meeting the Simpler-regime criteria as of 1 January 2024 do not have to apply the proposed implementation of the Basel 3.1 standards set out in this CP.[6] Instead, these firms could enter the Transitional Capital Regime, with requirements that are substantively the same as the existing Pillar 1 framework in the CRR, until the implementation date for a permanent risk-based capital regime for the simpler regime. Effectively, this means those firms, which would all be smaller SA firms, would be able to continue using the existing Pillar 1 risk weights.

10.33 The existing Pillar 2A framework is designed to complement the existing Pillar 1 framework, and the PRA currently intends to retain it (including the 2017 refinements) for firms in the Transitional Capital Regime. Doing so would maintain the existing capital framework for those firms until the adoption of the permanent risk-based capital regime for the simpler regime. This may require the PRA to run and apply two Pillar 2 frameworks. The PRA intends to reflect on this further, and welcomes insights from firms and market participants on this topic.

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1. PRA Discussion Paper 1/21 **'A strong and simple prudential framework for non-systemic banks and building societies'**, April 2021.

2. Bank of England Policy Statement **'The Financial Policy Committee's approach to setting the countercyclical capital buffer'**, April 2016.

3. Further detail on the PRA's approach to buffers can be found in PRA Statement of Policy '**The PRA's methodologies for setting Pillar 2 capital**', July 2021 and PRA Policy Statement 8/21 **'Non-systemic UK banks: The Prudential Regulation Authority's approach to new and growing banks'**, April 2021.

4. Full details of the PRA's approach to the setting of the PRA buffer can be found in PRA Statement of Policy **'The PRA's methodologies for setting Pillar 2 capital'**, July 2021.

5. This effect is laid out in general terms. In practice, the PRA accepts that no firm and balance sheet is ever equal or static period on period. PRA buffer-setting is highly idiosyncratic based on a firm's own vulnerabilities to stress and consequential supervisory judgements. The PRA also recognises that the systemic buffers (which are set relative to impact of failure) do not overlap in purpose with the PRA buffer. Any additional PRA buffer amounts relating to Risk Management and Governance failings are also excluded from this high level overview.

6. As proposed in Chapter 2, firms that meet the Simpler-regime criteria would however be able to choose to be subject to the proposed implementation of the Basel 3.1 standards set out in this CP.

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CP16/22 – Implementation of the Basel 3.1 standards: Disclosure (Pillar 3)

Chapter 11 of CP16/22

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Content

Overview

11.1 This chapter sets out the Prudential Regulation Authority's (PRA) proposals to update its Pillar 3 disclosure requirements to reflect its proposals to update the framework for calculating Pillar 1 risk-weighted assets (RWAs) that are set out in this CP. The proposals set out in this chapter align the Pillar 3 disclosures of UK firms to the revised Basel disclosure standards.[1]

11.2 The proposals in this chapter would amend the Disclosure (CRR) Part of the PRA Rulebook.

11.3 The PRA proposes to modify, and in some instances delete, existing disclosure templates, as well as introduce new disclosure templates, to align disclosure requirements with the Basel 3.1 standards, and reflect the proposals set out elsewhere in this CP for the following risk areas:

- Credit risk:
  - Chapter 3 – Credit risk – standardised approach;
  - Chapter 4 – Credit risk – internal ratings based approach; and
  - Chapter 5 – Credit risk mitigation.
- Market risk (Chapter 6 – Market risk);
- Credit valuation adjustment (CVA) risk and counterparty credit risk (CCR) (Chapter 7 – Credit valuation adjustment and counterparty credit risk);
- Operational risk (Chapter 8 – Operational risk);
- Output floor (Chapter 9 – Output floor); and
- Capital and risk management summaries.

11.4 The PRA considers it important that the UK continues to align with international disclosure standards, in the form set out in the Basel 3.1 standards. This would help ensure that UK firms demonstrate the same level of transparency as their peers in other jurisdictions. The PRA considers that accurate and comprehensive disclosure on compliance with Pillar 1 requirements, and on the risk profiles of UK firms, would support international competitiveness and facilitate the exercise of market discipline on firms.

11.5 The PRA considers that the existing disclosure templates do not provide appropriate information on the PRA's proposed implementation of the Basel 3.1 standards in relation to the above risk areas. In order for firms to continue to disclose relevant information on Pillar 1 RWAs, certain existing disclosure templates would have to either be revised, or in some cases replaced, with entirely new templates to reflect the proposals set out in this CP. The PRA proposes to adopt the Basel 3.1 disclosure templates, without material deviations to the content or format.

11.6 The PRA proposes to continue to apply the existing proportionality approach set out in the Disclosure (CRR) Part of the PRA Rulebook whereby the frequency of disclosure is varied according to a firm's size category and listing status. The PRA proposes that large and listed firms disclose at the minimum frequency prescribed in the Basel 3.1 standards. All other firms would disclose the proposed templates at a frequency no greater than the existing minimum frequency of their Pillar 3 report. The proposed frequencies are set out in the sections that follow. The PRA considers that the proposed frequencies of the disclosure templates set out in this chapter reflect the different level of risks posed by firms of differing size and complexity to the financial system. The PRA considers that firms that would pose the greatest risk to financial stability should meet the disclosure frequency under the Basel 3.1 standards, and that those less likely to pose such risks should not be subject to the same disclosure obligations. The PRA considers that this is a proportionate approach to implementing the Basel 3.1 standards on disclosure.

11.7 The table below summarises the disclosure proposals by risk area, including the disclosure templates the PRA proposes to delete, the proposed new templates, and the existing templates that the PRA proposes to modify for firms in scope of the proposals in this CP. Where existing disclosure templates are proposed to be modified, a separate version of these templates would be disclosed by firms in scope of the proposals in this CP. The proposed new, as well as modified existing, disclosure templates in this chapter would be titled with the proposed prefix of 'UKB' to distinguish from the existing equivalent disclosure templates that Transitional Capital Regime (TCR) firms would continue to disclose.

Summary of proposed disclosure changes

Risk area	Delete	New	Amend
Credit risk (SA and IRB)	Nil	Nil	SA: UK CRD, UK CR4, UK CR5 IRB: UK CRE, UK CR6, UK CR6-A, UK CR7, UK CR7-A, UK CR10
Market risk	UK MRA, UK MRB, UK MR1, UK MR2A, UK MR2B, UK MR3, UK MR4	UKB MRA, UKB MRB, UKB MR1, UKB MR2, UKB MR3	Nil
Credit valuation adjustment	UK CCR2	UKB CVAA, UKB CVAB, UKB CVA1, UKB CVA2, UKB CVA3, UKB CVA4	Nil
Counterparty credit risk	Nil	Nil	UK CCR1
Operational risk	UK OR1	UKB OR1, UKB OR2 and UKB OR3	UK ORA
Output floor	Nil	UKB CMS1, UKB CMS2	Nil
Capital summaries	Nil	Nil	UK KM1, UK OV1

11.8 The proposals in this chapter are applicable to firms within the proposed scope of application for the Basel 3.1 standards, set out in Chapter 2 – Scope and levels of application. Firms that would be subject to the Transitional Capital Regime would not be required to implement the proposals in this chapter, and could continue to report the existing requirements set out in the Disclosure (CRR) Part of the PRA Rulebook ahead of the finalisation of that regime.

Credit risk

11.9 Chapters 3 to 5 set out the PRA's proposed changes to credit risk RWA calculation requirements, and Chapter 12 – Reporting presents the corresponding proposals for regulatory reporting. The proposed changes to Pillar 3 disclosures reflect the revisions outlined in these chapters.

11.10 To help to ensure that firms continue to disclose relevant information, the PRA proposes to update nine existing disclosure templates for credit risk as follows.

Standardised approach (SA)

11.11 The PRA proposes to make the following amendments to the existing SA disclosure templates to broadly align the disclosures with the templates under the Basel 3.1 standards but with UK-specific modifications to reflect the PRA's proposed implementation of the SA:

Qualitative

- **UKB CRD template:**
  - The PRA proposes to update the instructions to refer to the Commission Implementing Regulation (EU) 2016/1799 of 7 October 2016. This is not a change under the Basel 3.1 standards but has been included to update referencing to the correct technical standards for the mapping of credit ratings.

Quantitative

- **UKB CR4 template:**
  - The PRA proposes modifications to add the new 'specialised lending' exposure sub-class, and the more granular real estate exposure sub-classes introduced by the PRA's proposals. This aligns with the Basel 3.1 standards, with the UK-specific implementation proposals incorporated into the template.
- **UKB CR5 template:**
  - The PRA proposes to amend this template to include additional risk weights introduced under the PRA's proposals as well as the new 'specialised lending' exposure sub-class, and the more granular real estate exposure sub-classes.
  - The PRA proposes to introduce a further table, that aligns with the Basel 3.1 standards, that would require firms to disclose: (i) their on-balance sheet exposures; (ii) their off-balance sheet exposures before the application of conversion factors (CFs); (iii) the corresponding weighted average CF applied to the off balance sheet exposures; and (iv) the on- and off-balance sheet exposures after the application of CFs and CRM, all broken down by risk weight bucket.

Internal ratings based (IRB) approach

Qualitative

11.12 The PRA proposes to make the following amendments to broadly align the existing IRB disclosure templates with the templates under the Basel 3.1 standards:

- **UKB CRE template:**
  - The PRA proposes to modify this template with the addition of a single new row that would require firms to disclose a description of progress on transitioning equity exposures from IRB to SA.

Quantitative

- **UKB CR6 template:**
  - The PRA proposes to modify this template by editing a single column that would remove reference to support factors. Firms would no longer disclose risk weighted exposure amounts net of support factors.
- **UK CR6-A template:**
  - The PRA proposes to modify this template by:
    - deleting the exposure class rows for central governments and central banks and for equity;
    - editing the exposure row labels for institutions, corporates, and retail to reflect the new class groupings; and
    - adding in new rows for the new IRB exposure sub-classes.
- **UKB CR7 template:**
  - The PRA proposes to modify this template by deleting, amending, and adding rows to reflect the new exposure sub-classes as per the changes made in template UK CR6-A.
- **UKB CR7-A template:**
  - The PRA proposes to modify this template by deleting, amending, and adding rows to reflect the new exposure sub-classes as per the changes made in template UK CR6-A.
- **UKB CR10 template:**
  - The PRA proposes to modify this template by amending the labelling of the slotting categories and changes to the risk-sensitivity of the slotting approach.
  - The PRA proposes to delete the equity exposure table entirely as the IRB approach would no longer be applicable for equity exposures.
  - The PRA proposes that firms disclose exposures to income-producing real estate and high volatility commercial real estate in separate tables.

11.13 The PRA proposes to retain the existing disclosure frequencies of these templates as it applies to firm size and listing status.

Market risk

11.14 Chapter 6 sets out the PRA's proposed implementation of the Basel 3.1 standards for market risk and Chapter 12 presents the corresponding proposals for regulatory reporting. The Pillar 3 disclosures proposed in this chapter reflect the proposals outlined in these chapters, including the recalibrated version of the existing standardised approach (SSA), the introduction of the new alternative standardised approach (ASA), and the new internal model approach (IMA).

11.15 To help ensure that firms continue to disclose relevant information with respect to the corresponding approaches used for calculating market risk capital requirements, the PRA proposes to introduce five new market risk disclosure templates and delete seven existing disclosure templates. The proposed new templates, which are described below, would align the firms' market risk disclosures with the Basel 3.1 standards.

Qualitative

- **UKB MRA template**:
  - The PRA proposes that all firms would be required to disclose a qualitative narrative around their strategies and processes for managing and monitoring market risk. This would include reference to any relevant policies and controls, and details of how market risk positions of instruments are assigned to the trading book or banking book, alongside the identification of any changes in allocation between reporting periods.
  - The PRA proposes that firms disclose details on their market risk management function, including the organisational structure and supporting governance. Firms would also need to disclose the scope and nature of their market risk reporting and/or measurement systems.
  - Firms categorised as 'large' and 'other' under the CRR, both listed and non-listed, would need to disclose this template on an annual frequency.
- **UKB MRB template**:
  - The PRA proposes that firms using the IMA would be required to disclose qualitative information on the structure of trading desks subject to IMA approval, as well as the types of instruments traded by these desks.
  - The PRA proposes that firms disclose descriptions of the specific models used, including the expected shortfall (ES) model, models used for calculating stress scenario risk measure (SSR) for non-modellable risk factors (NMRFs), and default risk capital charge (DRC-IMA) models. Firms would be required to provide details of the trading

desks covered by these models, a description of the models themselves including their parameterisation, and how firms have met internal capital adequacy assessments for these models.
- Firms would also be required to disclose the approaches used to validate the models employed, and to outline any assumptions and benchmarks relied upon.
- Firms categorised as 'large' and 'other' under the CRR, both listed and non-listed, would need to disclose this template on an annual frequency.

Quantitative

- **UKB MR1 template**:
  - The PRA proposes that all firms applying the ASA to their market risk exposures disclose this template, which would provide details on the capital requirements for the following ASA components, as well as the overall ASA capital requirement:
    - the sensitivities-based method for the specific risk class calculated for the ASA;
    - default risk for the specific risk class calculated for the ASA; and
    - the residual risk add-on calculated for the ASA.
  - The proposed frequency for disclosure for all listed and non-listed 'large' firms and 'other' listed firms is semi-annual. For 'other' non-listed firms, the disclosure frequency would be annual.
- **UKB MR2 template**:
  - Firms using the IMA would be required to disclose information on the different components for the capital requirement under the IMA for market risk.
  - Firms would be required to disclose an accompanying narrative describing:
    - the components that are included for their most recent risk measure and the components that are included for their average of the previous 60 days for ES, internally modelled capital charge (IMCC) and SSR, and 12 weeks for DRC-IMA;
    - a comparison of value-at-risk (VaR) estimates with actual gains/losses experienced by the firm; and
    - any significant change between the prior two disclosure periods and the key drivers of such changes.
  - The frequency of disclosure is proposed to be quarterly for 'large' listed firms, semi-annual for 'large' unlisted firms and 'other' listed firms, and annual for 'other' unlisted firms.
- **UKB MR3 template**:

- All eligible firms that use the SSA would need to disclose the different components for the capital requirement calculation under this approach. The proposed disclosure would include the total capital requirement as well as a breakdown across the different risk classes by specific approaches, and of securitisation positions.
- The proposed frequency for disclosure for all listed and non-listed ‘large’ firms and ‘other’ listed firms is semi-annual. For ‘other’ non-listed firms, the frequency would be annual.

Credit valuation adjustment

11.16 Chapter 7 sets out the PRA’s proposed implementation of the Basel 3.1 standards on CVA and Chapter 12 presents the corresponding proposals for regulatory reporting. The Pillar 3 disclosures proposed in this section reflect the proposals outlined in these chapters.

11.17 To help ensure that firms continue to disclose relevant information on the underlying calculation components and capital requirements for CVA, the PRA proposes to introduce six new disclosure templates on CVA, and to delete the existing UK CCR2 template. The proposed new templates described below would align CVA disclosures with the Basel 3.1 standards on disclosure.

Qualitative

- **UKB CVAA template**:
    - All firms that are required to calculate CVA capital requirements would be required to disclose this template which includes qualitative information on a firm’s CVA risk management objectives and policies.
    - In addition, firms would be required to disclose their eligibility for, and application of, the alternative approach (AA-CVA) whereby the capital requirement for CVA is set at 100% of the capital requirement for counterparty credit risk.
    - Firms categorised as ‘large’ and ‘other’ under the CRR, both listed and non-listed, would be required to disclose this template at an annual frequency.
- **UKB CVAB template**:
    - Firms that use the SA-CVA methodology to calculate their capital requirement for CVA would be required to disclose qualitative information on the main characteristics of their CVA risk management framework. This would include a description of that framework, the role of senior management within it, and an overview of the governance surrounding it.
    - Firms categorised as ‘large’ and ‘other’ under the CRR, both listed and non-listed, would need to disclose this template at an annual frequency.

Quantitative

- **UKB CVA1 template**:
  - Firms that use the reduced (simplified) BA-CVA approach to measure their CVA capital requirement either partially or fully would be required to disclose the key underlying components of the capital requirements calculation alongside the total capital requirement for CVA under this approach.
  - Firms would be required to describe the types of hedge instruments used even if these are not taken into account under the reduced BA-CVA.
  - The proposed frequency for disclosure for all listed and non-listed 'large' firms and 'other' listed firms is semi-annual. For 'other' non-listed firms, the frequency would be annual.
- **UKB CVA2 template**:
  - Firms that use the full BA-CVA approach to measure their CVA capital requirement would be required to disclose the capital requirement calculated under the full BA-CVA, where calculations under the reduced and the hedged BA-CVA would need to be included.
  - The proposed frequency for disclosure for all listed and non-listed 'large' firms and 'other' listed firms is semi-annual. For 'other' non-listed firms, the proposed frequency would be annual.
- **UKB CVA3 template**:
  - Firms that use the SA-CVA either partially or fully to calculate their capital requirement for CVA would be required to disclose the underlying capital requirement components by the six asset classes applicable, alongside the overall capital requirement for CVA under this approach.
  - The proposed frequency for disclosure for all listed and non-listed 'large' firms and 'other' listed firms is semi-annual. For 'other' non-listed firms, the frequency would be annual.
- **UKB CVA4 template**:
  - Firms applying the SA-CVA either partially or fully to calculate their CVA capital requirement would be required to disclose two consecutive reporting period values of capital requirements and supplement any significant changes in values with a narrative explaining the key driver of the changes.
  - The proposed frequency for disclosure for all listed and non-listed 'large' firms and 'other' listed firms would be quarterly. For 'other' non-listed firms, the frequency would be annual.

Counterparty credit risk

11.18 Chapter 7 sets out the PRA's proposed implementation of the Basel 3.1 standards on CCR and Chapter 12 presents the corresponding proposal for regulatory reporting. The Pillar 3 disclosures proposed in this chapter reflect the proposals set out in Chapter 7, namely the targeted reduced recalibrations to the standardised approach to the counterparty credit risk (SA-CCR) framework for calculating exposures to non-financial counterparties (NFCs) and pension scheme arrangements. To achieve this overall recalibration, the PRA proposes to reduce the SA-CCR alpha factor from 1.4 to 1 for transactions with NFCs and pension scheme arrangements.

11.19 The PRA proposes updating one existing disclosure template, UK CCR1.

- **UKB CCR1 template:**
  - 'Large' and listed 'other' firms are already required to complete this template. The extent of the modifications is the amendment of two rows, the addition of two rows, and an addition of a single column. The PRA proposes to add two rows that would separately disclose the calculation for NFCs and pension scheme arrangements under the SA-CCR and simplified SA-CCR approaches so that an alpha factor of 1 (instead of 1.4) can be used for computing the regulatory exposure value.
  - A proposed new column would disclose the additional capital 'add-on' required to be held for legacy transactions and new transactions with NFCs and pension scheme arrangements.
  - The existing frequency of disclosure for this template is proposed to be retained for all firms in scope of the proposals.

Operational risk

11.20 Chapter 8 sets out the PRA's proposed implementation of the Basel 3.1 standards on operational risk and Chapter 12 presents the corresponding proposals for regulatory reporting. The Pillar 3 disclosures proposed in this section reflect the proposals outlined in these chapters.

11.21 The proposals in this section would introduce new Pillar 3 templates that align with the templates under the Basel 3.1 standards in terms of content and format, to assist firms in disclosing information on the SA and historical losses under the PRA's proposed implementation of the Basel 3.1 standards. The PRA proposes to modify one existing Pillar 3 template (UK ORA), delete one existing template (UK OR1), and introduce three new disclosure templates which are described below for firms in scope of the proposals in Chapter 8.

Qualitative

- **UKB ORA template:**
  - The PRA proposes to modify UK ORA to disclose an outline of the operational risk management organisational structure and control function, operational risk measurement system, the scope and main content of the reporting to the executive function and board of directors, and the use of risk mitigation and risk transfer in managing operational risk.
  - This proposed disclosure frequency would remain annual for all firms in scope of Chapter 8.

Quantitative

- **UKB OR1 template – historical losses:**
  - The PRA proposes to introduce a disclosure template on historical losses that reflects the proposal set out in Chapter 8 for firms to develop policies and procedures for gross loss definitions, loss reference dates and the grouping of losses, and the Basel disclosure standards. Only firms with a business indicator (BI) greater than £0.88 billion would disclose UKB OR1. The proposed template would disclose aggregate operational losses incurred over the past ten years, based on the accounting date of the incurred losses, consistent with loss reserve recognition in a firm's profit and loss (P&L). The PRA proposes to set the threshold for including a loss event in the loss dataset at £20,000, and firms would be required to separately disclose losses greater than £20,000 and greater than £90,000 when disclosing loss data. The PRA considers that disclosure on operational risk losses would improve the transparency on operational risk events.
  - This proposed disclosure frequency of this template would be annual, aligned with the Basel 3.1 standards.
- **UKB OR2 template – business indicator and subcomponents:**
  - The PRA proposes that firms disclose the BI, its subcomponents, and a granular breakdown of the subcomponents, which inform the operational risk capital requirement calculation. The proposed disclosures would be reported over a three-year retrospective basis.
  - This proposed disclosure frequency for all firms of this template would be annual, aligned with the Basel 3.1 standards.
- **UKB OR3 template – minimum required capital:**
  - The PRA proposes that firms would disclose the minimum operational risk capital requirement, based on a value of 1 for the ILM and the business indicator component

(BIC).

- The PRA does not propose that firms disclose the ILM result in UKB OR3, consistent with the proposed calibration of the ILM to 1 in Chapter 8.
- This proposed disclosure frequency of this template would be annual, aligned with the Basel 3.1 standards.

11.22 The proposals for the quantitative disclosures expand the scope of the existing CRR approach whereby non-listed 'other' firms are not required to make quantitative operational risk disclosures. Under the proposals in this section, these firms would be required to disclose quantitative information to facilitate comparability with other firms.

Output floor

11.23 Chapter 9 sets out the PRA's proposed implementation of the Basel 3.1 standards for the output floor, and Chapter 12 presents the corresponding proposals for regulatory reporting. The proposed Pillar 3 disclosures set out in this section reflect the proposals as set out in these chapters.

11.24 To help to ensure that firms would disclose relevant information in respect of this new methodology, the PRA proposes to introduce two new disclosure templates on the output floor that are aligned with the Basel 3.1 standards.

- **UKB CMS1 template:**
  - Firms with internal model permissions to calculate RWAs would disclose this template at the consolidated level to which the output floor applies and by risk type.
  - Firms would disclose:
    - RWAs computed for the modelled approaches firms have permission to use;
    - RWAs for a firm's portfolio where the SA is used;
    - total RWA, which is the summation of the modelled RWA and the standardised RWA calculated above; and
    - RWA calculated for all risks using only the SA and prior to the application of the output floor.
  - **UKB CMS2 template**:
    - Firms with permission to use the IRB approach for calculating credit risk would be required to disclose the following information in this template:
      - RWAs calculated using the IRB approach, broken down by exposure class;
      - equivalent standardised RWAs by exposure class;

- total RWAs which sum the RWAs calculated from the IRB approach and the SAs above, by exposure class; and
- RWA calculated for all risks using only the SA and prior to the application of the output floor.

11.25 The frequency for disclosing the information in template UKB CMS1 is proposed to be quarterly for 'large' listed firms, semi-annual for 'large' non-listed firms and 'other' listed firms, and annual for 'other' non-listed firms ('large' and 'other' as defined under the CRR). For template UKB CMS2, the proposed disclosure frequency is semi-annual for 'large' listed and non-listed firms as well as 'other' listed firms, and annual for 'other' non-listed firms.

Consequential updates to capital summary disclosures

11.26 The PRA proposes to implement the revisions under the Basel 3.1 standards relevant to the existing templates UK KM1 and UK OV1 for all firms within the proposed scope of application of the Basel 3.1 standards. The key changes proposed are described below.

- **UKB KM1 template**:
  - The PRA proposes to revise UK KM1 to disclose the total RWAs, the Common Equity Tier 1 (CET1), Tier 1, and total capital ratios separately before the output floor is applied;
  - additional rows are also proposed to disclose capital metrics reflecting fully loaded expected credit losses (ECL) once the International Financial Reporting Standard (IFRS) 9 transitional ceases to apply to an individual firm; and
  - minor revisions to row titles to reflect the terminology used in the Basel standards on KM1 disclosure.
- **UKB OV1 template**:
  - Proposed revisions include new rows reflecting the revised Pillar 1 RWA approaches set out in this CP, and the output floor.

11.27 The PRA proposes to retain the existing disclosure frequency based on firms' size and listing status.

PRA objectives analysis

11.28 The PRA considers that the proposal to introduce new disclosure requirements for the PRA's implementation of the Basel 3.1 standards would support UK firms in providing transparent and consistent information on their credit risk RWAs, and market, CVA, and operational risk capital requirements, output floor RWAs, and key metrics to users of the

Pillar 3 report. This would aid comparability of firms operating both within the UK and in other jurisdictions adopting the Basel 3.1 standards which would facilitate the continued exercise of market discipline, and in turn advance the PRA's primary objective of safety and soundness.

11.29 The proposed disclosure templates in this chapter intends to maintain the international alignment of UK firms' disclosures with the Basel disclosure standards. The PRA considers that the standardisation and alignment of the proposed disclosures in this CP would support its secondary competition objective, by ensuring that firms disclose in a consistent way. The PRA considers that the proposed frequencies for non-listed and 'other' category firms is proportionate, which supports competition for firms with relatively smaller balance sheets, and with differing participation in capital markets.

'Have regards' analysis

11.30 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Proportionality (FSMA regulatory principles and Legislative and Regulatory Reform Act 2006):

- The PRA considers that the disclosure proposals set out in this section would be proportionate to firms applying the new risk methodologies and reflect the internal data needed by firms to monitor their risks under the calculation proposals set out in this CP, as well as to report on these risks to the PRA. The proposed templates are aligned with the disclosure templates under the Basel 3.1 standards, except where the proposals set out elsewhere in this CP would render certain content not relevant for UK firms (eg ILM result).
- For the operational loss disclosure, the proposed application threshold aims to ensure that loss event disclosure is limited to larger, more complex firms.
- The CVA and market risk disclosure proposals allow firms to apply three different approaches, and the proposed disclosure templates vary according to the methodology applied.
- The PRA proposed disclosure frequencies for large non-listed and all other firms aim to ensure that the proposed disclosures are proportionate to firm's size and capital market activity. The PRA considers its approach proportionate by recognising the different levels of risks posed by firms of differing levels of complexity.

2. Senior management responsibility (FSMA regulatory principles):

- The PRA considers that the disclosure proposals would continue the existing PRA requirement for management body or senior management to maintain internal processes, systems, and controls to verify that the firm's disclosures are appropriate and in compliance with PRA rules, including the existing attestation requirement. The proposals set out in this chapter would increase the volume of disclosures subject to senior management oversight and attestation.

3. Different business models (FSMA regulatory principles):

- The proposed CVA, market, and credit risk frameworks include a range of different proposed approaches intended for different types of firms with different business models and capabilities. The disclosure proposals reflect the inherent variability in potential capital calculation approaches associated with these business models.

4. PRA publishing information relating to persons on whom requirements are imposed, or requiring such persons to publish information (FSMA regulatory principles):

- The PRA recognises that the disclosure proposals in this chapter would impose a requirement on firms to publish the necessary information and the PRA has, in its proposals, broadly adopted the content of the Basel 3.1 standards that other international jurisdictions are anticipated to adopt.

5. Relevant international standards (FSMA CRR rules):

- The PRA considers its disclosure proposals presented in this chapter align with international standards and templates in content, and would help to ensure that UK firms are publishing consistent and comparable information on RWAs as their peers in different jurisdictions. Meeting international standards would support confidence in UK firms and their international competitiveness. However, in certain cases, the PRA proposes to deviate from the disclosure frequencies under the Basel 3.1 standards by maintaining its existing requirements that are based on the size and listing status of firms.

6. Transparency (Legislative and Regulatory Reform Act 2006):

- Proposed new rules are being consulted on as part of this consultation. All proposed requirements are set out objectively in the draft rule instrument. The proposed requirements are accompanied by the proposed reporting and disclosure templates. Together, this material should set out clearly to firms what requirements would apply, and the format in which the PRA proposes that firms should comply. This chapter and the accompanying appendices aim to provide firms with a clear picture of the proposed impact of the reporting and disclosures requirements.

7. Consistency (Legislative and Regulatory Reform Act 2006):

- The PRA proposes to implement the content of the Basel disclosure templates and therefore, UK firms would be required to disclose information on a consistent basis at a UK level and also internationally.

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1. Basel Committee on Banking Supervision (BCBS) **'Disclosure requirements'**, published in December 2018 for a Basel recommended effective date of 1 January 2023.

Appendices

Appendix 4: Draft PRA Rulebook (CRR) Instrument [2023] (PDF 4.1MB)

Appendix 18: Draft updated disclosure templates (Please find the link below):

Credit risk

CP16/22 - Annex XIX – Credit Risk SA Disclosure templates (XLSX 0.2MB)

CP16/22 - Annex XX - Credit Risk SA Disclosure instructions (PDF 0.8MB)

CP16/22 - Annex XXI + Annex XXIII - Credit Risk IRB Disclosure templates (XLSX 0.2MB)

CP16/22 - Annex XXII + Annex XXIV Credit Risk IRB Disclosure instructions (PDF 1MB)

FRTB market risk

CP16/22 - Annex XXIX - Market Risk Disclosure templates (XLSX 0.1MB)

CP16/22 - Annex XXX - FRTB Risk Disclosure instructions (PDF 0.8MB)

Credit valuation adjustment

CP16/22 - Annex XXXIX - CVA Disclosure templates (XLSX 0.1MB)

CP16/22 - Annex XXXXX - CVA Disclosure instructions (PDF 0.8MB)

Counterparty credit risk

CP16/22 - Annex XXV - CCR Disclosure template (XLSX 0.1MB)

CP16/22 - Annex XXVI - CCR Disclosure template instructions (PDF 0.7MB)

Operational risk

CP16/22 - Annex XXXI - Operational Risk Disclosure templates (XLSX 0.1MB)

CP16/22 - Annex XXXII - Operational Risk Disclosure instructions (PDF 0.8MB)

Output floor

Annex I - Output floor Disclosure templates (XLSX 0.1MB)

CP16/22 - Annex II - Output Floor Disclosure instructions (PDF 0.8MB)

Capital summary

CP16/22 - Annex I - UKB KM1 and UKB OV1 templates (XLSX 0.1MB)

CP16/22 - Annex II - UKB KM1 instructions (PDF 0.8MB)

CP16/22 - Annex II - UKB OV1 instructions (PDF 0.8MB)

Previous chapter Next chapter

CP16/22 – Implementation of the Basel 3.1 standards: Reporting

Chapter 12 of CP16/22

Published on 30 November 2022

Content

Overview

12.1 This chapter sets out the Prudential Regulation Authority's (PRA) proposals for how firms would report on the proposed framework for the calculation of Pillar 1 risk-weighted assets (RWAs) to the PRA.

12.2 The proposals in this chapter would result in changes to:

- the Reporting (CRR) Part of the PRA Rulebook (Appendix 4);
- the Regulatory Reporting Part of the PRA Rulebook;
- the Reporting Pillar 2 Part of the PRA Rulebook; and
- Supervisory Statement (SS) 34/15 – 'Guidelines for completing regulatory reports' (Appendix 19).

12.3 The proposals in this chapter would update COREP, Capital+, and FSA005 reporting requirements to reflect the proposed methodologies for the calculation of Pillar 1 RWAs:

- Credit risk:
  - Chapter 3 – Credit risk – standardised approach;
  - Chapter 4 – Credit risk – internal ratings based approach; and
  - Chapter 5 – Credit risk mitigation.
- Market risk (Chapter 6 – Market risk)
- Credit valuation adjustment (CVA) risk (Chapter 7 – Credit valuation adjustment and counterparty credit risk)
- Operational risk (Chapter 8 – Operational risk)
- Output floor (Chapter 9 – Output floor).

12.4 The proposals set out in this chapter include:

- revisions to existing COREP templates and instructions on own funds, and own funds' requirements to reflect the proposals set out in this CP;
- the deletion of certain COREP templates that would become obsolete under the proposals in this CP;
- the introduction of new COREP templates to reflect the proposed new Pillar 1 RWA calculations, and internal model use conditions proposed in this CP;
- deletion of the FSA005 Market risk template to reflect the proposed discontinuation of the 'risks not in value-at-risk' (RNIV) methodology for the calculation of market risk; and

- revisions to the Capital+ templates and instructions to reflect the proposals set out in this chapter.

12.5 The proposed reporting requirements amend existing and introduce new reporting requirements that reflect the revised approaches to RWA calculation under the Basel 3.1 standards. Where existing reporting requirements would become partly or entirely redundant due to the proposed revision of RWA requirements, the PRA proposes to replace the existing templates entirely with new templates. The PRA considers that the proposed reporting changes are necessary to remove reporting requirements associated with RWA calculation methodologies that would become obsolete under the proposals in this CP, and to reflect new proposed RWA calculation approaches, including internal model use conditions.

12.6 Updating regulatory reporting would enable the PRA to collect the necessary data to understand what firms' capital requirements are and how those requirements are being calculated. This proposed reporting is important for the supervision of the broader proposals in this CP, and for monitoring across the industry.

12.7 The PRA proposes to make only the minimum changes to reporting that are necessary to implement the Basel 3.1 standards. In due course, the PRA plans to review the full range of bank reporting data it collects to seek improvements and efficiencies. In considering any future changes, the PRA intends to take into account available insights from the **transforming data collection** programme being implemented by the Bank of England and Financial Conduct Authority (FCA). This work would not be completed ahead of proposed implementation of the Basel 3.1 standards, and is unlikely to fundamentally change the information collected on the Basel 3.1 methodologies.

12.8 The proposed reporting templates and instructions are attached to this CP (see Appendix 20), alongside proposed amendments to SS34/15 and the reporting rule instruments. The table below sets out the reporting proposals for the implementation of the Basel 3.1 standards by risk area. The PRA proposes to modify 12 existing COREP templates and the three existing Capital+ templates, introduce 19 new COREP templates, and delete eight existing templates.

Summary of proposed reporting changes

Risk area	Delete	New	Amend existing
Credit risk	C10.01, C10.02	Nil	SA: C02.00, C07.00, C09.01 IRB: C02.00, C08.01, C08.02, C08.03, C08.05, C08.05.1, C08.06, C08.07, C09.02, C34.07
Market risk	C24.00, FSA005	CAP24.01, CAP24.02, CAP24.03, CAP25.01, CAP25.02, CAP25.03, CAP25.04, CAP25.05, CAP25.06, CAP25.07, CAP25.08, CAP25.09, CAP25.10, CAP25.11	C02.00
CVA	C25.00	CAP26.01, CAP26.02, CAP26.03	C02.00
Operational risk	C16.00, C17.01, C17.02	CAP16.00	C02.00
Output Floor	Nil	CAP02.01	C02.00, C08.01
Capital	Nil	Nil	C02.00, PRA101, PRA102, PRA103

12.9 Where existing reporting templates are proposed to be modified, the existing version would be retained for Transitional Capital Regime (TCR) firms, with the new version of these templates that are proposed in this chapter intended for reporting by firms in scope of the proposals in this CP. The proposed new, as well as amended, reporting templates in this chapter are titled with a temporary prefix of ‘CAP’ for the purposes of the description within this CP and in the relevant appendices, in order to distinguish the proposals from the existing reporting templates that TCR firms would continue to report. The proposed Capital+ templates would be renamed to PRA101a, PRA102a, and PRA103a for the purposes of this CP.

12.10 The proposals set out in this chapter are applicable to firms within the proposed scope of application for the Basel 3.1 standards, set out in Chapter 2 – Scope and levels of application. Firms that would be subject to the TCR would not be required to implement the proposals in this chapter, and could continue to report the existing requirements set out in the Reporting (CRR) and Regulatory Reporting Parts of the PRA Rulebook ahead of the finalisation of that regime.

Credit risk

12.11 Chapters 3 to 5 set out the PRA's proposed changes to credit risk RWA calculation methodologies. These proposed changes to calculating credit risk would fundamentally alter the existing approaches and it would not be possible for the PRA to monitor and supervise compliance by firms in scope of this CP with the Basel 3.1 credit risk framework using existing COREP templates. The proposed changes to reporting reflect the proposed revisions outlined in chapters 3 to 5 to the standardised approach (SA), the internal ratings based (IRB) approach, and credit risk mitigation (CRM), used to compute RWAs for credit risk.

12.12 The PRA proposes to modify two existing SA templates (C07.00 and C09.01), modify nine existing IRB templates (C08.01, C08.02, C08.03, C08.05, C08.05.1, C08.06, C08.07, C 09.02, and C34.07) and delete two existing IRB templates (C10.01 and C10.02) such that firms report relevant data that reflect the updated credit risk RWA calculation approaches. Proposed credit risk revisions to CAP02.00 are set out in paragraph 12.35.

Standardised approach (SA)

12.13 For firms that apply the SA, the PRA proposes to amend three existing COREP templates and instructions to align with the proposed changes to the SA set out in Chapter 3. The proposed amendments would:

- align the templates to reflect relevant exposure sub-classes and the increase in the conversion factor for off-balance sheet commitments;
- remove references to elements which the PRA proposes to remove from the framework, such as the small and medium-sized enterprise (SME) and infrastructure support factors;
- add memorandum items to include reporting on the transitional provisions for equity exposures; and
- amend the templates to reflect the increased granularity of risk weights applicable to exposures across the proposed credit risk SA requirements, and to include specific reporting on relevant collective investment undertakings.

Internal ratings based (IRB) approach

12.14 For firms that apply the IRB approach, the PRA proposes to amend 10 existing COREP templates and instructions to align with the proposals set out in Chapter 4. The proposed amendments would:

- remove references to elements which the PRA proposes to remove from the framework, such as the SME and infrastructure support factors and the double default treatment;
- introduce new elements such as data points on conversion factors, adjustments to risk weighted exposure amounts and expected loss, and the probability of default (PD) input floor; and
- augment reporting on CRM by adding data points regarding on-balance sheet netting and aligning with the proposed exposure sub-classes.

12.15 The PRA proposes to delete C10.01 and C10.02 to reflect the proposal that the IRB approach should no longer apply to exposures to equities. The PRA does not propose to revise C08.04 and proposes to keep existing scope and reporting frequency of all modified templates.

Market risk

12.16 Chapter 6 sets out the PRA's proposed changes to the calculation of market risk capital requirements, and the proposed conditions for the use of the market risk approaches. The proposed changes to market risk RWA calculation requirements envisage three approaches, two of which are entirely new. This renders some existing COREP and FSA templates on market risk redundant, and therefore not suitable for the supervision of proposed SA and internal model approach (IMA) requirements.

12.17 The PRA proposes to introduce new templates on the SA and IMA approaches, as well as summary reporting on which market risk capital requirement calculation approaches are in use across a firm's market risk portfolio. The proposed new approaches for market risk would require new data and calculation processes within firms both to internally monitor, and report on, Pillar 1 compliance. Only a subset of these templates would apply to all firms, depending on the market risk approaches used by a firm.

12.18 The PRA proposes that all firms in scope of this CP would report a new market risk summary template (CAP25.11) to identify which market risk methodologies they are applying, and to collect information on the relevant eligibility requirements for the derogations for small trading book business and the exemptions from the SA. Proposed market risk revisions to CAP02.00 are set out in paragraph 12.35.

Standardised approach

12.19 For firms that intend to apply the new market risk SA to all or part of their portfolio, the PRA proposes to introduce 10 new templates.

CAP25.01–25.07 templates

- Seven new templates are proposed to separately report on the underlying risk classes that a firm may be exposed to, as set out in Chapter 6. Each template reports the sensitivities measures and the corresponding sensitivities-based method (SbM) capital requirement for positions corresponding to the risk buckets for each risk class. Firms would be required to report the delta, vega, and curvature sensitivities positions for each risk bucket, under three different correlation scenarios. Firms would only complete the templates for the risk classes for which they have an exposure.

CAP25.08 template

- This proposed template captures the default risk capital (DRC) requirements under the SA. Firms would report their positions on a gross jump-to-default basis (JTD).

CAP25.09 template

- This proposed template captures the residual risk add-on (RRAO) capital requirements under the advanced standardised approach (ASA). Firms would report their positions by residual risk type and value.

CAP25.10 template

- This proposed template captures the capital requirements for investment in funds calculated using either the mandate based approach or third-party calculated risk-weight look-through approach under the ASA. Firms would report a breakdown by five risk classes (general interest rate risk, credit spread risk for non-securitisations, equity, commodity, and foreign exchange).

Internal model approach (IMA)

CAP24.01, CAP24.02, CAP24.03

12.20 The PRA proposes that all firms using the IMA to calculate market risk would report the following new templates for all or part of their portfolio subject to the IMA:

CAP24.01 template

- This proposed template reports the main risk measures (expected shortfall (ES)) of the IMA capital requirements. Firms would report a breakdown of capital requirements by different components under the ES measures, and the different risk classes prescribed under the IMA framework.

CAP24.02 template

- This proposed template reports the capital requirements for the other risk measures, namely the capital requirements for non-modellable risk factors (NMRFs), default risk charge (DRC-IMA), and risks not in model (RNIM). The proposed reporting is further split by risk classes.

CAP24.03 template

- This proposed template would require information at a firm level, and at each trading desk level for which a firm has approval to use the IMA. This template would report information on back-testing and profit loss attribution testing (PLAT) at portfolio level and trading desk level. Firms would need to report for each daily observation date (ie T+0 until T+280). The PRA proposes collecting the information at a trading desk level, as the data would be required to assess whether firms' trading desk(s) continue to meet the relevant requirements to be capitalised under the IMA.

12.21 The PRA proposes to delete templates C24.00 and FSA005 that report market risk capital requirements under the existing IMA, which would become obsolete under the proposals in Chapter 6. The PRA proposes that firms using the IMA also report templates CAP25.01 to CAP25.10 on the standardised approach for the relevant pair of their IMA portfolio.

Simplified standardised approach (SSA)

12.22 The PRA does not propose to make any changes to COREP templates C18.00–C23.00 which would continue to be reported by firms that will apply the SSA. Minor amendments are proposed to the instructions for C18.00–C23.00 to replace references to the CRR with the proposed PRA Rulebook references as set out in Appendix 4, including a clarification that the new multipliers in Article 325(2) of the Market Risk: General Provisions (CRR) Part should apply to the aggregated risk class-level own funds requirements reported in COREP templates C18.00–C23.00 (as proposed in paragraph 6.31 of Chapter 6).

12.23 The proposed frequency for all new market risk reporting (CAP24.01 to CAP25.11) would be quarterly, with a 30 business day remittance period, which is consistent with existing COREP reporting on market risk and capital requirements.

Credit valuation adjustment (CVA)

12.24 Chapter 7 sets out the PRA's proposals to introduce a new CVA framework comprising of three new standardised methodologies to calculate CVA capital requirements. COREP template C25.00 on CVA risk currently reports CVA capital requirements according to the existing methodology which would become obsolete under the proposals in Chapter 7. The existing structure of C25.00 cannot be easily modified to capture the RWA and capital requirements under the proposed new methodologies.

12.25 The PRA proposes to delete C25.00 for firms in scope of the proposals in Chapter 7. C25.00 would be replaced by three proposed new CVA templates that report on the CVA results at a summary level, as well as on a detailed basis under each CVA capital requirement calculation approach used. Proposed CVA risk revisions to C02.00 are set out in paragraph 12.35.

12.26 The PRA proposes three new reporting templates that would consist of:

CAP26.01 template

- The PRA proposes that all firms in scope of the proposals in Chapter 7 would report a new CVA summary template (CAP26.01), which would provide the PRA with information on which CVA approach is being applied for the purpose of supervising the calculation approach. The proposed template would also summarise the CVA capital requirements. Firms applying the alternative approach (AA-CVA) would only report this template.

CAP26.02 template

- The PRA proposes that firms applying the basic approach (BA-CVA) methodology complete a separate template (CAP26.02). Firms may choose whether to apply the full version of BA-CVA, where hedges are recognised, or the reduced version of BA-CVA, where hedges are not recognised.
- Firms using both the full and the reduced version of BA-CVA would report a breakdown of their capital requirements by systematic and idiosyncratic components. Firms using the full version of BA-CVA would apply this breakdown for K-reduced, and K-hedged, which are inputs to its calculation, as well as including the hedge misalignment component for K-hedged.
- The information reported in this template would support the supervision of the correct application of the BA-CVA approaches and provide key information on the drivers of firms' capital requirements for CVA risk.

CAP26.03 template

- The PRA proposes that all firms applying the standardised approach (SA-CVA) methodology report a dedicated template on this approach (CAP26.03). The template would collect data on the granular decomposition of CVA capital requirements across six asset classes as set out in Chapter 7.
- The proposed CAP26.03 template would provide the PRA with the key information to supervise whether firms are complying with the new SA-CVA methodology, monitor firms' capital requirements between periods, and assess the key drivers of any material changes to the values of the underlying risk factors.

12.27 The PRA proposes that firms would submit CAP26.01 to CAP26.03 to the PRA on a quarterly basis, following a 30 business day remittance period. The proposed quarterly frequency is aligned with that of other existing reporting on own funds and own fund requirements.

Counterparty credit risk

12.28 In line with the proposals in Chapter 7, the PRA proposes to apply targeted recalibrations to the SA to the counterparty credit risk (SA-CCR) framework for calculating exposures to non-financial counterparties (NFCs) and pension scheme arrangements. As the necessary reporting amendments to reflect the CCR proposals in Chapter 7 would be small, the PRA does not propose to amend the existing CCR COREP templates at this time. The PRA considers that it would not be proportionate to revise reporting now, while firms may still be embedding the most recent changes to the CCR reporting requirements. The PRA may consider amending reporting to reflect the CCR changes in Chapter 7 in the future in connection with the review ambitions set out in paragraph 12.7. Instead of amending reporting templates, the PRA proposes to update reporting instructions for template C34.02 that would enable firms to complete the existing template under the new requirements.

Operational risk

12.29 The PRA's proposals to implement the Basel 3.1 standards for operational risk are set out in Chapter 8. The existing reporting of Pillar 1 operational risk which currently reports on the existing methodologies across three templates would become redundant under the operational risk proposals set out in this CP. As the proposed Basel 3.1 SA methodology is structurally different to the three existing methods, the PRA considers the existing templates cannot easily be modified.

12.30 The PRA, therefore, proposes to delete the existing COREP templates C16.00, C17.01, and C17.02 for firms in scope of the proposals in Chapter 8. CAP16.00 is proposed to replace these templates. The PRA's proposed operational risk revisions to CAP 2.00 are set out in paragraph 12.35. The PRA proposes that CAP16.00 would report on the following elements:

- **Approvals:** All firms in scope of the proposals in Chapter 8 would be required to complete this section on the excluded activities from SA capital requirement calculations, and a firm's position relative to the threshold for reporting historical loss data under the PRA's proposed implementation of the Basel 3.1 standards. The information captured would support the PRA in monitoring that firms are correctly applying the methodologies according to the correct approvals and thresholds.
- **Business indicator (BI) and subcomponents:** All firms in scope of the proposals in Chapter 8 would be required to report the BI, its subcomponents, and the granular

breakdown of the subcomponents, which inform the operational risk capital requirements calculation. The granular items required would be reported in accordance with the measurement and recognition principles applied under the IFRS or the applicable GAAP regime. Firms reporting FINREP may use the same data definitions for the corresponding items reported in FINREP. The PRA proposes that the BI and subcomponents would be reported for the three years preceding the reporting reference date.

- **Business indicator component (BIC):** All firms in scope of Chapter 8 would report the BIC.
- **Minimum required capital:** All firms in scope of Chapter 8 would report the minimum operational risk capital requirement and the operational risk capital requirements based on a value of 1 for the internal loss multiplier (ILM).
- **Historical losses:**
  - Consistent with the proposed requirement for firms to follow specific criteria for the identification, collection, and treatment of internal loss data and develop policies and procedures in support of this, the PRA proposes that firms with a BI greater than £0.88 billion would report aggregate operational losses incurred over the past 10 years.[1]
  - This proposed reporting coverage is based on the accounting date of the incurred losses (ie when a loss reserve position is recognised in a firm's profit and loss). Firms currently report historical loss data as part of Pillar 2A assessment.
  - The PRA proposes to set the threshold for including a loss event in the loss data set reported at £20,000, and firms would be required to report separately losses greater than £20,000 and greater than £90,000 when reporting loss data.
  - The PRA considers that building an operational risk loss data set in this way would facilitate improved and closer management of operational risk events, which supports firms' overall management of systems, processes, and governance. It would also provide the PRA with consistent loss data to better support cross-firm comparison.

12.31 The PRA proposes that firms would submit CAP16.00 to the PRA on a quarterly basis, with a 30 business day remittance period, which is consistent with existing COREP reporting requirements on operational risk capital requirements.

Output floor

12.32 The PRA's proposals to implement the Basel 3.1 standards for the output floor are set out in Chapter 9. As the output floor would be a new requirement, the PRA proposes to introduce new reporting, and update existing reporting, on total RWAs to help ensure the transparent and accurate application of the framework. The proposed additions would introduce the reporting on the output floor, as well as an asset class level breakdown of

RWAs calculated using only SAs. The PRA considers this would allow it to understand the relative levels of floored and unfloored RWAs, as well as the critical factors influencing the binding measure of RWAs.

12.33 In order for the PRA to supervise whether firms are accurately complying with the output floor requirements, the PRA proposes to modify two existing templates (C02.00 and C08.01) and introduce one new template.

12.34 The proposed output floor reporting requirements would apply to firms in scope of Chapter 9 in the following way:

- on a consolidated basis only, at the UK consolidation level (ie the ultimate UK group level) of UK headquartered groups;
- on an individual basis for UK stand-alone firms (eg at the solo entity level); and
- on a sub-consolidated basis for ring-fenced body (RFB) sub-groups, or individual basis where the RFB is not part of a ring-fenced sub-group.

12.35 The reporting template proposals relevant to the output floor are as follows:

C02.00 template

- The PRA proposes to amend the existing template C02.00 to reflect the revised credit Pillar 1 RWA calculation requirements and market, operational, and CVA risk Pillar 1 capital requirements calculation set out in this chapter as follows:
  - replace rows that collect data under the existing methodologies that would be removed under the Basel 3.1 standards across the different risk areas with the proposed new approaches; and
  - add in rows for firms to indicate the percentage of total RWA (using SAs only) taken to set the output floor – the output floor multiplier applicable to the reporting period, and whether or not the floor is binding.
- In order for this reporting template to adequately reflect the proposed output floor, the PRA proposes to add two columns to this template that would require firms within scope to report:
  - capital requirement for the equivalent SAs, for each row where firms use internal models to calculate capital requirements; and
  - capital requirement under the application of the output floor (ie an aggregate of all capital requirements using SAs), incorporating the output floor multiplier applicable for the reporting period which would allow the PRA to compare, in parallel, the total RWAs using modelled approaches and the output floor.

C08.01 template

- The PRA proposes to modify the existing template C08.01 to reflect the reporting requirements it considers essential for supervising the application of the SA to credit risk for the purposes of the output floor. The proposals include:
  - adding new columns to report SA equivalent exposure at default (EAD) and RWAs at the total exposure level; and
  - adding new rows to report unrated corporates for the purposes of assessing the application of the more risk-sensitive approach to this exposure class.

CAP02.01 template

- All firms in scope of the proposals in Chapter 9 would report this new template.
- Firms would report RWAs for standardised and modelled approaches presently applied, alongside the total RWA for their portfolio, and RWAs using SAs only. The values would be reported by risk type.

12.36 The PRA proposes that these templates would be collected quarterly, with a 30 business day remittance period, which is consistent with existing COREP reporting on RWAs.

Capital+

12.37 The Capital+ templates PRA101, PRA102, and PRA103 are based on the COREP summary templates C01.00–C04.00, and report on current and forecast capital requirements. The PRA's proposed changes to the credit, market, operational, and CVA risk RWAs, and the proposed introduction of the output floor would necessitate changes to PRA101 to 103 to align with the proposed changes to CAP02.00.

12.38 The PRA has considered whether it is necessary for firms to report the same level of granularity in the Capital+ templates as that of CAP02.00 and proposes to take a proportionate approach, by only requiring firms to provide high level forecast information, rather than report all the rows specified in CAP02.00. The PRA proposes that all firms in the proposed scope of application for the Basel 3.1 standards (see Chapter 2) would report revised versions of Capital+ (PRA101a, PRA102a, and PRA103a in this CP).

12.39 The PRA proposes to revise Capital+ as follows:

- add new rows specific to output floor, reported by risk category, to report the standardised equivalent capital forecast when the output floor is expected to bind; and
- delete and replace rows related to operational risk, market risk, and CVA RWA proposals set out in this CP with the proposed new calculation approaches.

PRA objectives analysis

12.40 The PRA considers that the proposal to introduce new reporting templates for the PRA's proposed implementation of the Basel 3.1 standards would enable the PRA to monitor levels of risk and capital and supervise firms' compliance with these standards. This would reduce the risk of firms being inadequately capitalised in respect of credit, market, CVA, and operational risks that may arise in future, thereby advancing the PRA's primary objective of safety and soundness.

12.41 The PRA considers it has approached the design of its proposed reporting requirements in a proportionate manner, and limited the proposed new and revised data to that essential to understand and supervise capital requirements calculated in accordance with the proposals set out in this CP. The PRA considers that reporting would enable the PRA to assess that all firms comply with the Basel 3.1 standards equally rather than seeking competitive advantage by not complying. The PRA considers that its reporting proposals would therefore not adversely impact competition.

'Have regards' analysis

12.42 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA), the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Proportionality (FSMA regulatory principles and Legislative and Regulatory Reform Act 2006):

- The templates have been designed to capture only the minimum essential data that would allow the PRA to credibly assess compliance and supervise a firm's implementation of the Basel 3.1 standards.
- For the CAP 16.00 operational risk reporting proposals, the underlying financial items to the subcomponents of the BI are defined with respect to FINREP data items and existing accounting practices, which seeks to minimise the new reporting burden on firms. Additionally, the PRA proposes that only larger firms with a BI exceeding £0.88 billion would need to report the historical losses elements of the template.
- The CVA and market risk reporting proposals would allow firms to apply three different approaches, corresponding to different levels of complexity and risk-sensitivity, proportionate to the CVA and market risk faced by firms.

2. Efficient use of PRA resources (FSMA regulatory principles):

- The PRA proposes to introduce the new reporting into the existing COREP framework in order to minimise the PRA resources required to integrate a change to its data collection systems.
- The PRA has considered directly sourcing the collection of the operational risk BI elements from firms' FINREP returns in order to reduce the reporting burden to firms. However, this would mean firms would be submitting incomplete information for the purposes of the capital calculation, resulting in additional requirements for supervisors to source and match relevant data from FINREP to COREP in order to analyse operational risk requirements, for each firm. The PRA, therefore, considers that aligning the reporting definitions with FINREP give firms sufficient synergies in template preparation, resulting in a modest burden on firms in support of the timely and efficient analysis of operational risk requirements by the PRA.

3. Different business models (FSMA regulatory principles):

- The proposed CVA, market, and credit risk frameworks include a range of different approaches intended for different types of firms with different business models and capabilities. The reporting proposals reflect the inherent variability in potential capital calculation approaches associated with these business models.

4. Relevant international standards (FSMA CRR rules):

- The reporting proposals set out in this chapter would allow the PRA to supervise compliance with the proposals set out in this CP, and materially align with the Basel 3.1 standards.

Taxonomy implementation

12.43 The PRA currently collects banking data using two different taxonomies. COREP is reported to the PRA using the European Banking Authority (EBA) authored taxonomy (version 3.0). The Bank of England Banking Taxonomy (version 3.5.1) is used to report other banking reporting including certain PRA, FSA, and ring fenced body (RFB) titled data items.

12.44 The reporting proposals in this chapter would need to be implemented within a taxonomy authored by the Bank of England. For COREP, this approach would mean that firms in the proposed scope of application for the Basel 3.1 standards (see Chapter 2) would no longer report own funds and own fund requirements (eg COR001a) to the PRA using an EBA authored taxonomy from the PRA's proposed implementation date (see Chapter 1 – Overview). Firms applying the simpler regime would continue to report the own funds and own fund requirements in COREP using EBA Taxonomy 3.0.

12.45 The PRA is considering how best to implement the reforms given the existing dual reporting taxonomies. The PRA intends to publish the public working draft taxonomy following this CP for comments on the data modelling and overall technical implementation.

12.46 The PRA is also considering how to maintain the clarity of reporting requirements around which templates are applicable to firms in the proposed scope of application for the Basel 3.1 standards (see Chapter 2) and TCR firms via template naming conventions, to help to ensure that the reporting requirements for firms in scope of this CP and TCR firms are sufficiently distinguishable. The PRA has set out temporary prefixes and suffixes for the proposed reporting set out in this CP of 'CAP' for COREP and 'a' for Capital+. However, these prefixes or suffixes may be subject to future change as the PRA transitions away from the EBA authored taxonomy.

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1. The PRA proposes that thresholds stated in EUR or USD in the Basel 3.1 standards are converted into GBP (see Chapter 13 – Currency redenomination).

Previous chapter Next chapter

Appendices

- Appendix 4: Draft PRA Rulebook (CRR) Instrument [2023] (PDF 4.1MB)
- Appendix 19: Draft amendments to Supervisory Statement SS34/15 – Guidelines for completing regulatory reports (PDF 1.7MB)

Appendix 20: Draft updated reporting templates and instructions (Please find the link below):

Credit risk

- CP16/22 - Annex I - Credit Risk Reporting templates (XLSX 0.3MB)
- CP16/22 - Annex II - Credit Risk Reporting instructions (PDF 1.4MB)

FRTB market risk

- CP16/22 - Annex I - Market Risk Reporting templates (XLSX 0.2MB)
- CP16/22 - Annex II - Market Risk Reporting instructions (PDF 1.2MB)

Credit valuation adjustment

- CP16/22 - Annex I - CVA Reporting template (XLSX 0.1MB)
- CP16/22 - Annex II - CVA Reporting Instructions (PDF 0.9MB)

Counterparty credit risk

- CP16/22 - Annex II - CCR Reporting instructions (PDF 0.7MB)

Operational risk

- CP16/22 - Annex I - Operational Risk Reporting template (XLSX 0.1MB)
- CP16/22 - Annex II - Operational Risk Reporting instructions (PDF 0.8MB)

Output floor

- CP16/22 - Annex I - Output Floor Reporting templates (XLSX 0.1MB)
- Annex II - Output Floor Reporting instructions (PDF 0.8MB)

Capital summary

- CP16/22 - PRA 101a, 102a, 103a templates (XLSX 0.3MB)
- CP16/22 - PRA 101a instructions (PDF 0.9MB)
- CP16/22 - PRA 102a instructions (PDF 0.9MB)
- CP16/22 - PRA 103a instructions (PDF 0.8MB)

CP16/22 – Implementation of the Basel 3.1 standards: Currency redenomination

Chapter 13 of CP16/22

Published on 30 November 2022

Content

Overview

13.1 This chapter sets out the Prudential Regulation Authority's (PRA) proposals to redenominate certain references to Euros (EUR) and US Dollars (USD) into Pound Sterling (GBP) in the PRA rules proposed in this Consultation Paper (CP).

13.2 The Capital Requirements Regulation (CRR) and the Basel 3.1 standards contain a number of thresholds and monetary values set in EUR. In transposing Capital Requirements Directive V (CRD V), the PRA redenominated EUR thresholds relating to the identification of material risk takers (MRTs) in the Remuneration Part of the PRA Rulebook.[1] Subsequently, the PRA applied a consistent methodology when redenominating thresholds in respect of other regulatory changes.[2]

13.3 The PRA proposes to continue applying this methodology to the proposals covered in this CP, specifying EUR thresholds and monetary values in GBP when implementing the Basel 3.1 standards, and in making PRA rules that cover material that is currently covered in the CRR.

13.4 Additionally, the PRA proposes a separate but similar, methodology to redenominate in GBP certain thresholds and monetary values in USD including those within CRR articles that are stated in EUR but based on a USD threshold in Basel standards.

13.5 The proposals in this chapter affect rules in the following proposed new or amended parts of the PRA Rulebook:

- Credit Risk: Standardised Approach (CRR);
- Credit Risk: Internal Ratings Based Approach (CRR);
- Credit Risk Mitigation (CRR);
- Market Risk: Advanced Standardised Approach (CRR);
- Market Risk: General Provisions (CRR);
- Market Risk: Internal Model Approach (CRR);
- Operational Risk;
- Credit Valuation Adjustment Risk; and
- Reporting (CRR).

13.6 The proposals in this chapter are relevant to PRA-authorised banks, building societies, PRA-designated investment firms, and PRA-approved or PRA-designated financial holding companies or mixed financial holding companies ('firms'). The proposals would not apply to

UK banks and building societies that meet the Simpler-regime criteria and choose to be subject to the Transitional Capital Regime proposals.[3]

Methodology and proposals

13.7 When redenominating thresholds and monetary values expressed in EUR in the Basel standards, the PRA proposes to use the same methodology to calculate the GBP/EUR exchange rate as that used in the implementation of other regulatory changes ie based on the average daily GBP/EUR spot exchange rate over a representative historical 12-month period. For consistency with the exchange rate used in other regulatory changes, the PRA proposes to use the average daily rate over the 12-month period prior to Friday 10 July 2020, rounded to two decimal places: £1 = €1.14. The PRA also proposes to round the redenominated GBP values to two significant figures.

13.8 In a small number of instances, the existing CRR provisions include EUR thresholds and monetary values that have been converted from USD-denominated thresholds in the Basel standards. Instead of converting from those EUR thresholds in the CRR, the PRA proposes to convert the thresholds direct from the USD value in the Basel standards and apply the average daily GBP/USD spot exchange rate covering the 12-month period prior to Friday 10 July 2020, rounded to two decimal places: £1 = $1.26. Other thresholds in the Basel standards in USD would also be converted using the same methodology.

13.9 The PRA considers that using the same exchange rate as that used in the implementation of other regulatory changes would mean that thresholds and monetary values are treated in a consistent manner to other PRA rules. The PRA intends to keep the proposed GBP/EUR and GBP/USD exchange rates applied under review. Based on the average daily spot exchange rates over the 12-month period prior to the end of the most recent calendar quarter before publication of final rules, if either of the resulting exchange rates differ from those set out above by 20% or more, the PRA proposes instead to use the relevant updated exchange rate.

13.10 For ease of reference, Tables 1, 2, 3, and 4 list the PRA rules for which the PRA proposes to set thresholds and monetary values in GBP, together with the proposed GBP value, assuming the rates set out in this chapter are applied.

Table 1 – Proposed GBP thresholds and monetary values (EUR)

Relevant PRA rule	Summary	EUR (€)	Proposed GBP (£)
Article 178(2)(da)(i) of the Credit Risk: Internal Ratings Based Approach (CRR) Part	Threshold for the total amounts past due, below which non-retail exposures are classified as ‘immaterial’ in the credit risk framework	500	440

Table 2 – Proposed GBP thresholds and monetary values (EUR millions)

Relevant PRA rule	Summary	EUR (€ million)	Proposed GBP (£ million)
Rule 1.2 Definition of ‘corporate SME’ in the Credit Risk: Standardised Approach (CRR) Part	Annual sales threshold for the consolidated group which a corporate SME is a part of, below which the exposure qualifies as a corporate SME in the credit risk SA framework	50	44
Article 123A(3) of the Credit Risk: Standardised Approach (CRR) Part	Threshold for maximum total exposure to one counterparty, below which exposures can qualify as Regulatory Retail exposures in the credit risk SA framework	1	0.88
Article 147(4E)(b)(ii) of the Credit Risk: Internal Ratings Based (IRB) Approach (CRR) Part	Annual revenues threshold for the consolidated group which a general corporate is a part of, above which advanced internal ratings based (AIRB) cannot be applied in the credit risk IRB framework (‘Large Corporates’)	500	440
Article 147(5)(a)(ii) of the Credit Risk: Internal Ratings Based Approach (CRR) Part	Threshold for maximum total exposure to one counterparty, below which exposures qualify for retail treatment in the credit risk IRB framework	1	0.88
Article 147(5A)(c) of Credit Risk: Internal Ratings Based Approach (CRR) Part	Threshold for the maximum exposure to a single individual in a sub-portfolio, below which exposures qualify as a revolving retail exposure in the credit risk IRB framework	0.1	0.09
Article 153(4) of the Credit Risk: Internal Ratings Based Approach (CRR) Part	Maximum annual sales threshold for the consolidated group which a corporate is a part of, to be used in the firm size adjustment in the corporate IRB formula[4] in the credit risk IRB framework	50	44

Article 153(4) of the Credit Risk: Internal Ratings Based Approach (CRR) Part	Minimum annual sales threshold for the consolidated group which a corporate is a part of, to be used in the firm size adjustment in the corporate IRB formula4 in the credit risk IRB framework	5	4.4
Article 208 (3)(b) of the Credit Risk Mitigation (CRR) Part	Threshold for exposure value of a loan, above which property valuations for that loan shall be reviewed at least every three years in the credit risk mitigation framework	3	2.6
Rule 7.1 (4) of the Operational Risk Part	The minimum threshold for including a loss event in the data collection in the operational risk framework	0.02	0.02
Article 446(1) of the Reporting (CRR) Part	The minimum threshold for including a loss event in the data collection in the operational risk framework	0.02	0.02
Article 356(1)(c) of the Market Risk: Simplified Standardised Approach (CRR) Part	Threshold for firms with agricultural commodities business, above which average own funds requirements for this risk cannot be exceeded in the market risk SA framework	1	0.88
Article 325a(1) of the Market Risk: General Provisions (CRR) Part	Threshold for on- and off-balance-sheet business that is subject to market risk, above which firms are not eligible to use the simplified standardised approach in the market risk SA framework	500	440

Table 3 – Proposed GBP thresholds and monetary values (EUR billions)

Relevant PRA rule	Summary	EUR (€ billion)	Proposed GBP (£ billion)
Rule 6.1(1) of the Credit Valuation Adjustment Risk Part	Threshold for aggregate notional amount of non-centrally cleared derivatives, below which firms may use the alternative approach in the CVA framework	100	88
Rule 5.8 of the Operational Risk Part	Business indicator threshold to determine if a firm's marginal coefficient is in bucket 1 or 2 in the operational risk framework	1	0.88
Rule 5.8 of the Operational Risk Part	Business indicator threshold to determine if a firm's marginal coefficient is in bucket 2 or 3 in the operational risk framework	30	26
Article 446(1) of the Reporting (CRR) Part	Business indicator threshold above which firms must disclose loss events in the operational risk framework	1	0.88

Table 4 – Proposed GBP thresholds and monetary values (USD billions)

Relevant PRA rule	Summary	USD ($ billion)	Proposed GBP (£ billion)
Article 142(4)(a) of the Credit Risk: Internal Ratings Based Approach (CRR) Part	Threshold for total assets of a financial sector entity (or its parent company), above which it is classified as a large financial sector entity in the credit risk IRB framework	100	79
Rule 5.28(1) of the Credit Valuation Adjustment Risk Part	Threshold for market capitalisation of equities, above which they are considered as large cap equities in the CVA framework	2	1.6
Article 325i (3)(e) of the Market Risk: Advanced Standardised Approach (CRR) Part	Threshold for market capitalisation of all the constituents of the listed index, above which firms are eligible to use a look-through approach in the market risk SA framework	40	32
Article 325BD(9) of the Market Risk: Internal Model Approach (CRR) Part	Threshold for market capitalisation of equities, above which they are considered as large cap equities in the market risk advanced SA and IMA framework	2	1.6

PRA objectives analysis

13.11 The PRA considers that it is appropriate for PRA rules to specify thresholds and monetary values in GBP. The PRA considers that its proposals would provide a methodology that would maintain the relative sizes of thresholds and monetary values set out in the Basel 3.1 standards after redenomination. Specifying values in GBP would reduce the extent to which variations in the GBP/EUR or GBP/USD exchange rates require immediate changes in the requirements applicable to firms. The PRA considers that this would reduce the risk of inconsistency in the application of the prudential framework and therefore supports the PRA's primary objective of promoting the safety and soundness of firms.

'Have regards' analysis

13.12 In developing these proposals, the PRA has had regard to the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from 2021 and the supplementary recommendation letter sent April 2022. Where the proposed new rules are CRR rules (as defined in section 144A of FSMA),

the PRA has also taken into consideration the matters to which it is required to have regard when proposing changes to CRR rules. The following factors, to which the PRA is required to have regard, were significant in the PRA's analysis of the proposals:

1. Relevant international standards (FSMA CRR rules):

- The PRA considers that its proposed methodology for converting the thresholds stated in international standards is designed to align with such standards.

2. Proportionality (FSMA regulatory principles):

- The PRA considers that the proposals set out in this chapter also support the proportionality of the prudential framework. The specification of thresholds and monetary values in GBP would reduce the extent of change in requirements applicable to firms that result from variations in exchange rates.

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1. PRA Policy Statement 29/20 – **'Capital Requirements Directive V (CRD V): Final policy'**, December 2020.
2. This includes the PRA Policy Statement 22/21 – **'Implementation of Basel standards: Final rules'**, October 2021 and the PRA Policy Statement 21/21 – **'The UK leverage ratio framework'**, October 2021.
3. Chapter 2 – Scope and levels of application also describes the position for PRA-designated financial holding companies or mixed financial holding companies related to those UK banks and building societies.
4. For the purposes of calculating the coefficient of correlation, R, in the IRB formula for corporates in Article 153(4) of the Credit Risk: Internal Ratings Based Approach (CRR) Part, the PRA proposes to replace values in the formula to the GBP converted values as set out. The PRA also proposes to calculate the difference between these converted thresholds, 39.6, and substitute this for 45 in the calculation.

Appendices

Appendix 4: Draft PRA Rulebook (CRR) Instrument [2023] (PDF 4.1MB)

Previous chapter