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BASEL 3.1 – TEN KEY TAKEAWAYS ON UK IMPLEMENTATION PROPOSALS

On 12 September 2024, the PRA published its Policy Statement PS9/24 *Implementation of the Basel 3.1 Standards*, accompanied by a set of near-final rules and new and revised supervisory statements, and confirmed January 2026 as the UK implementation date. Taken together, these publications amount to a sizeable package of around 1000 pages and form the second of two instalments of the PRA's Basel 3.1 implementation package. In this briefing we give our initial reactions on the top ten themes that we find most interesting, with a focus on some of the particular features of the PRA's implementation: how the PRA's approach has changed from its opening consultation position, and how it varies from the EU's CRR3 regime.

Key issues

- This briefing sets out our initial reactions to the following key issues related to UK Basel 3.1 implementation:
- Commitments.
- Residential Mortgages.
- Specialised Lending (non-real estate)
- Commercial Mortgages.
- Credit Risk Insurance.
- Collateralised Guarantees.
- Credit Derivatives.
- Removal of the SME and Infrastructure Supporting Factors.
- The Output Floor.
- Pillar 2.

INTRODUCTION

On 12 September 2024, the PRA published its Policy Statement PS9/24 *Implementation of the Basel 3.1 Standards*[1], accompanied by a set of near-final rules and new and revised supervisory statements. Taken together, these publications amount to a sizeable package of around 1000 pages and form the second of two instalments of the PRA's Basel 3.1 implementation package (the first having been published in December 2023[2]).

To call the package "long-awaited" would be quite an understatement, drafts of the rules originally having been published nearly two years ago (with Consultation Paper CP16/22[3]). While the time between publication of drafts to near-final rules is largely attributable to the importance and complexity of the rules, publication was further delayed due to the snap UK general election earlier this year.

In this briefing we give our initial reactions on the top ten themes that we find most interesting, with a focus on some of the particular features of the PRA's

[1] PS9/24 – Implementation of the Basel 3.1 standards near-final part 2

[2] PS17/23 – Implementation of the Basel 3.1 standards near-final part 1

[3] CP16/22 – Implementation of the Basel 3.1 standards

implementation: how the PRA's approach has changed from its opening consultation position, and how it varies from the EU's CRR3 regime. Other briefings will focus on particular aspects of the package, in due course.

BACKGROUND TO BASEL 3.1

Basel 3.1—also referred to variously as Basel 3 final, endgame or Basel 4—is the name given to Basel Committee on Banking Supervision's (BCBS) final post-financial crisis amendments to the Basel standards agreed in December 2017. It is often conflated with the near contemporaneous amendments to the BCBS's market risk standards—the Fundamental Review of the Trading Book (FRTB). BCBS standards do not have the force of law and are subject to implementation by local law in member jurisdictions. The BCBS had originally proposed a January 2022 implementation deadline, which was pushed back to January 2023 during the pandemic and, which will now not take effect in the UK until January 2026.

The previous iteration of the Basel Standards was the Basel 3 regime. Basel 3 was implemented across the EU primarily by the Capital Requirements Regulation 575/2013 (CRR), which came into effect in 2014. The CRR has been revised on several occasions, but, save for refinements to the liquidity requirements and the treatment of securitisations, derivatives and some SFTs, previous changes to the CRR have been *relatively* minor. Like other EU regulations, the CRR was onshored into UK law on Brexit, as UK CRR. The EU CRR will be significantly revised, mostly with effect from January 2025, by the EU's own Basel 3.1- implementing measure, Regulation 2024/1623 (CRR3).

CRR3 AND UK IMPLEMENTATION - FORMAL DISTINCTIONS

The key distinction between the PRA's Basel 3.1 package and the CRR is a formal one. CRR3 amends, rather than replaces the EU CRR. Conversely, the PRA's Basel 3.1 package mostly comprises a set of new PRA Rulebook Parts and chapters, replacing the bulk of the UK CRR its entirety. This continues, but escalates, a trend that started in 2021, when the PRA was empowered to produce its own CRR rules by the Financial Services Act 2021. That said, the new CRR rules are closely based on and preserve the original numbering of the legacy CRR texts, and so the new rules can quite easily be compared against both the current UK CRR text and the EU CRR text as amended by CRR3.

OUR TOP TEN TAKEAWAYS FROM PRA BASEL 3.1 IMPLEMENTATION

Commitments

When a bank enters into a commitment to lend – i.e. grants an undrawn or a partially drawn credit facility - it incurs a so-called **off-balance sheet** exposure to the would-be borrower. This off-balance-sheet exposure generates capital requirements for the bank, on much the same basis as a fully-drawn loan would, albeit subject to a credit conversion factor (CCF). That has long been the case, but the rules governing capital requirements for such commitments have

historically been open to interpretation, uncertainty and inconsistent application, not only across different jurisdictions but also even from bank to bank or departments of the same bank. Basel 3.1 seeks to harmonise and regularise the treatment of such off-balance-sheet items to remedy this[4], while also imposing 10% CCFs for unconditionally cancellable commitments (which, until now, bore a 0% CCF).

Basel 3.1 standards provided an optional derogation – whereby national rule-makers could exempt certain uncommitted commitments from such requirements (so long as, among other things, no fee is payable and the bank retains absolute discretion to lend on the day of a requested drawdown). This derogation has been reflected in the EU CRR (new article 5(10) as inserted by CRR3). By contrast, in CP16/22, the PRA stated that it did not propose to avail itself of the derogation, and the PRA has not changed its approach. Also, although the EU CRR3 has allowed for a delayed, transitional phase-in of the 10% CCF for unconditionally cancellable commitments, the PRA will introduce the 10% CCF with immediate effect from January 2026. That said, the PRA has confirmed that off-balance sheet exposures need not be assessed by reference to unadvised limits, allaying many of the concerns expressed by some commentators.

Residential Mortgages

Basel 3.1 overhauls the treatment in the Standardised Approach of both residential and commercial mortgage exposures. The general principles for this new regime were established by the BCBS and have been more-or-less faithfully implemented by the EU and PRA alike. However, the PRA consultation process has prompted several discussions on how to properly classify edge-cases between the commercial and residential mortgage classes.

A prime example is holiday lets. It is reasonably well established that buy-to-let (BTL) mortgages and mortgages for second homes fall within the residential mortgage exposure class, at least in the UK. In its CP16/22, the PRA had proposed that mortgages for holiday lets (among others) be expressly excluded from the residential mortgage exposure class. The PRA has softened its approach: in the near-final rules, mortgages for holiday lets (and for care homes, among other things) are no longer expressly and automatically *excluded* from the residential mortgage class – although the PRA maintains the view that it considers it " *unlikely that holiday lets, care homes and purpose-built student accommodation would meet the definition of residential real estate unless the property is capable of being resold as a standard residential dwelling in the event of the obligor's default*".

Basel 3.1 introduces the concept of "**regulatory real estate**". The optimal regulatory treatment is only available where a mortgage loan falls within that class. Among other things, a mortgage will *usually* only fall within this class where the secured property is "finished". At the other end of the spectrum, mortgages for the acquisition of land, for development and construction (so-called "**ADC**" mortgages) are, with some exceptions, to be given a 150% risk weight. This had prompted calls among those responding to the CP16/22 for exemptions or other allowances for self-build mortgage loans. The PRA has acknowledged such requests and will permit *some* self-build mortgage loans to

[4] How successful Basel 3.1 will be in harmonising the treatment of such exposures remains to be seen, as we are already seeing differences in implementation emerging among jurisdictions.

be treated as regulatory real estate mortgages, on certain conditions—including that the to-be-constructed property will be the borrower's primary residence—subject to valuation adjustments.

Specialised Lending (non-real estate)

Specialised lending is a term covering commercial loans for which the main source of repayment is the underlying asset. Specialised lending exposures include asset finance deals, project finance deals, some commodities finance loans and some real estate finance deals. The specialised lending regime was introduced into the (then-new) internal-ratings based (IRB)approaches by Basel 2.

The PRA's near-final rules revise the legacy CRR definition of "specialised lending" to add an additional criterion – that the borrower "*has little or no other material assets, and therefore little or no independent capacity to repay… apart from the income that it receives from the asset(s) being financed*". This criterion is lifted from the BCBS's text (dating back as far as Basel 2), but is not featured in the CRR (in its present or post-CRR3 form)[5] Whether this additional criterion is material depends in large part on whether one considers the specialised lending definition as a hard test to be construed literally, or as a broader test of economic substance. The tenor of the PRA's discussion in PSPS9/24 suggests the former, as does HMT's decision to align the cross-references to the additional criterion in the Securitisation Regulations 2024.Arguments can be made either way and further exploration of that particular point is outside the scope of this briefing.

Although some IRB banks treat specialised lending exposures in much the same way as other corporate loan exposures, others are required to apply the so-called "**slotting**" approach. The slotting approach imposes specific risk weights, whose severity depends on the political/economic context and commercial features of the deal, together with certain legal considerations, including factors such as, the quality of the security package. A key question, in recent years, has been whether banks can recognise the effect of extraneous credit protection in respect of slotted exposures. In recent Q&As and other post-Brexit publications, the EBA has implied that this might not be possible (i.e. that the bank must recognise the effect of any collateral when assigning its exposure to the relevant slot, or not at all). In its CP16/22, the PRA also suggested that collateral could not be recognised as further reducing a bank's already slotted exposures. The PRA's stance has changed, with the acknowledgment that additional collateral *might* be capable of recognition, so long as it is not double-counted.

Similarly, the PRA—as it had proposed in CP16/22—acknowledges that banks can recognise extraneous guarantees and other unfunded credit protection arrangements for slotted exposures (i.e. they can substitute the guarantor's risk weighting for the risk weight mandated by the slotting).However such recognition is only possible where the guarantor and guarantee complies with unfunded credit protection requirements for the risk weight substitution approach (i.e. where the guarantee complies with the standardised unfunded credit protection eligibility requirements, albeit within an IRB context).

[5] Although it can be argued that it is more-or-less implied by the longstanding criterion that "*the primary source of repayment of the obligation is income generated by the asset being finance, rather than the independent capacity*".

Basel 3.1 introduces specialised lending (for project, asset and commodities finance only) into the standardised regime too. The PRA, and the EU CRR3, broadly align with the BCBS's approach in this regard.

Commercial Mortgages

Basel 3.1's new standardised commercial mortgage regime bears many similarities to the new residential mortgage regime. Rather than imposing a flat risk weight, the BCBS had proposed a loan splitting or blended rating, either of which could—in theory—result in a less than 100% risk weight overall. The PRA had proposed to floor the risk weights for commercial mortgages at 100%, in keeping with its historical practice (the Basel 2 and CRR regime had, indeed, notionally permitted a 50% risk weight for commercial mortgages, but the UK has always maintained a 100% risk weight minimum). In its near-final rules the PRA has softened its stance—envisaging that, in very limited circumstances only—a less-than-100% risk weight might be available for some commercial mortgages.

As noted above, many IRB real estate financings fall within the specialised lending class. In its original conception of specialised lending, the BCBS envisaged two classes of real estate exposures: income producing real estate (**IPRE**) and high volatility commercial real estate (**HVCRE**), to which a more onerous treatment applies. When Basel 2 was implemented, the EU did not introduce an HVCRE class into its regulatory capital regime, an approach it has maintained under its CRR3 regime. By contrast, the PRAis introducing an HVCRE regime, despite some strong opposition. In its near-final rules, the PRA has revised its approach for the new HVCRE class, bringing it closer into line with the BCBS's definition.

With respect to slotting, banks are in principle only *required* to slot a specialised lending exposure where they are unable adequately to model the risks associated with the asset class for IRB purposes. However, in the early 2010s, the FSA required UK banks to slot all their IPRE exposures. A few years later, the PRA *seemed* to relax its predecessor's approach and slotting ceased to be mandatory for IPRE (although, in reality, the PRA expected or required most banks to slot their IPRE exposures anyway). The PRA is formally reintroducing mandatory slotting for all IPRE (and HVCRE) exposures under the IRB approaches.

Credit Risk Insurance

It is now well established that UK banks can recognise credit risk insurance as unfunded credit protection, in much the same way as guarantees. However, accommodating credit risk insurance policies to the recognition rules for guarantees can be a headache for banks and insurers alike. There have been calls for the introduction of a new risk mitigation regime, tailored specially for credit risk insurance (much as one for credit derivatives was introduced by Basel 2).

In the EU, CRR3 has appointed the EBA, alongside EIOPA, to write a report on the eligibility and use of credit risk insurance, with a view – potentially – to a forthcoming legislative proposal for such a tailored regime. That report was due in June of this year, but it has not yet been published. In response, perhaps, to any such forthcoming changes the PRA notes that "*should further evidence on*

the risk mitigation provided by credit insurance emerge which could justify a different approach for credit insurance, it would be preferable for this to be agreed internationally." In so doing, the PRA has given no indication as to whether and what alternative requirements it might support or tolerate for credit risk insurance.

Under the standardised and F-IRB approaches, banks may only rely on unfunded credit protection (guarantees and insurance alike) where the protection provider falls within one of the eligible protection provider classes. There is—at present—no specific eligibility class for insurers. In most cases, this means that commercially provided credit risk insurance is only eligible where the insurer has been awarded an insurer financial strength or similar rating by one of the rating agencies (or where the insured bank internally rates the insurer under the F-IRB approach). EU CRR3 will see the introduction of a new class for EU regulated insurers. The PRA, is however, preserving the status quo in this regard, and UK banks must continue to accommodate their credit insurers to the rated corporate class of protection provider.

In recent years, many commentators and industry bodies have pressed the regulators to allow banks to apply a lower LGD to insured exposures than that that generally attributable to unsubordinated claims (45%). The argument for this has been that, in many jurisdictions, insureds have super-senior claims on insurers for their insurance obligations. The PRA is standing firm on this issue, noting (though not in so many words) that most insurers have relatively few general creditors, and so any such preference is an illusion.

Collateralised Guarantees

Back in 2017, the PRA published its quarterly consultation paper, CP2/17, Chapter 2 of which related to the recognition of collateralised guarantees. The PRA suggested that a collateralised guarantee could only be recognised as credit protection where the guarantee satisfied all of the unfunded credit protection requirements, implying that the guarantor itself had also to satisfy the protection provider requirements (see above, re insurers). This prompted several questions: why should the standing of the guarantor be relevant if its obligations are fully collateralised (contrast the treatment of credit-linked notes and the synthetic securitisation rules)? When the PRA finalised the *other* policies and rules consulted upon in CP2/17, it deferred to comment or finalise Chapter 2, and nothing further was said on the subject—until now.

The PRA has confirmed that, so long as a collateralised guarantee satisfies all the relevant contractual recognition requirements, and the supporting collateral is itself eligible as funded credit protection, then it can be recognised as credit protection, regardless of the whether the guarantor would satisfy the protection provider requirements for a simple uncollateralised guarantee. However, it follows that if the collateral only partly covers a guarantee provided by an ineligible protection provider, the bank cannot rely on the uncollateralised portion of the guarantee as unfunded credit protection.

Credit Derivatives

Under the Basel 2-derived rules, a bank may only *fully* recognise a credit derivative as unfunded credit protection where its credit events include a restructuring event. It has long been argued that a restructuring credit event is

unnecessary where local corporate insolvency laws allow, in effect, for a financial restructuring (and, for this very reason such credit events are rare in US market practice). The BCBS had therefore proposed that local rule-makers might allow their supervisees to fully recognise such credit derivatives. CRR3 allows for this (in limited cases), but the PRA—in its CP16/22—indicated that it would not.

In its final rules, the PRA has changed its stance, and UK banks will be permitted to fully recognise such credit derivatives, where (among other things) the debtor's local insolvency laws merit the approach.

Removal of the SME and Infrastructure Supporting Factors

The PRA has decided to retire the so-called SME supporting factor (article 501 UK CRR). This is an element of the IRB approach, which purports to modify risk-weighted exposures under the IRB approach for SME loans. It is being retained, in the EU, under CRR3, but the PRA has concluded that it is not necessary. Instead the PRA's near-final rules will apply, on a firm by firm cases, an adjustment to Pillar 2 capital requirements so that the supporting factor's removal does not result in an overall increase in capital requirements for SME exposures. Furthermore, the overall effect of the removal of the SME supporting factor is to be balanced against pro-SME lending changes to the standardised approach.

The PRA's near-final rules also remove the UK CRR's infrastructure supporting factor (a more recent introduction into the CRR than the SME support factor), but its impact across the board is, perhaps, countervailed by PRA's willingness to grant a more favourable treatment for certain project finance exposures under the specialised lending regimes. The removal of both these supporting factors, and the mitigation of the potential impact on capital via structural adjustment to Pillar 2 requirements, headlined Phil Evans' recent speech at UK Finance following launch of the PRA's implementation package[6].

Output Floor

Basel 3.1 introduced the so-called "output floor" in response to concerns around model risk and uncertainty. The output floor is intended to operate as a 'backstop' that stops modelled risk-weighted assets (**RWAs**) from falling too far below those of the standardised approaches.

The output floor is perhaps the most notorious aspect of Basel 3.1. When fully phased-in, it would have the effect of requiring IRB banks to maintain capital requirements equal to 72.5% of the requirements that would have applied, had they been subject entirely to the standardised approach. In other words, it effectively imposes the standardised approach across all banks' businesses.

However, it is the international context that the output floor is, arguably, most significant – especially in light of the long-running Basel 3 endgame process in the US. A key issue in the PRA's implementation has therefore been the level at which the output floor should apply and, specifically, whether it should be imposed upon the UK subsidiaries of international groups. In its original CP16/22 proposal, the PRA had proposed to impose the output floor at a group

[6] Implementing Basel 3.1 in the UK − speech by Phil Evans

level (for UK-headquartered groups), but not on the UK-headed subgroups or subsidiaries of international groups, excepting ring-fenced bodies. The PRA's final position reflects this.

The output floor has other implications, insofar as it is applies to securitisations exposures – that is the subject of a separate consultation process, and a subject for a different briefing

The PRA has implemented the output floor in its rules largely as consulted on. However, it has made an adjustment to its near-final rules on the calculation of the floor, which adjusts for EL and accounting provisions, in order to better approximate the capital ratio that would have applied if all exposures had been subject to the SAs. This was in response to calls from consultation respondents for a calculation that brings output floor and SA methodologies into closer alignment.

Pillar 2

In CP16/22 the PRA set out a high-level description of the implications for Pillar 2 of the changes proposed to the Pillar 1 framework. This included aspects related to the Pillar 2A credit risk methodology, use of IRB benchmarks, and the interaction with the output floor. The Pillar 2A methodology and proposals on capital-related measures under the Strong and Simple framework (which would cover simplifications to Pillar 2) are the subject of separate consultations published at the same time as PS9/24[7].

However, as noted above, the near-final rules now include new firm-specific structural adjustments to reduce Pillar 2A capital requirements (the 'SME lending adjustment' and the 'infrastructure lending adjustment') to ensure that the removal of the SME support factor and infrastructure supporting factor under Pillar 1 does not result in an increase in overall capital requirements for SME exposures and infrastructure exposures respectively. How the capital reduction will operate is uncertain pending a further consultation on Pillar 2, timing for which is currently unclear. This leaves some firms concerned that the capital benefit provided by the supporting factors might not be matched by the structural adjustments to Pillar 2.

CONCLUSIONS

A policy statement and ruleset of the size and complexity of PS9/24 will take many weeks or months to fully comprehend. In this briefing we have focused in on just a few of the many points, in no particular order, and have attempted to shed some useful light on the PRA's approach. In some respects the PRA has, not unreasonably, stuck to its guns in the face of heavy advocacy, in others it has displayed a commendable pragmatism in its concessions. In other respects, it has teasingly or frustratingly held its silence—reserving its position, so as to respond to developing international trends.

[7] CP9/24 – Streamlining the Pillar 2A capital framework and the capital communications process and CP7/24 – The Strong and Simple Framework: The simplified capital regime for Small Domestic Deposit Takers (SDDTs) (these consultations close on 12 December 2024).

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