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# Implementation of Basel 3.1 Standards: An Update on PRA Reforms

## Introduction

On 12 September 2024, the UK Prudential Regulation Authority (PRA) published the second of two nearly final policy statements (PS9/24) on the implementation of revisions to the Basel 3 standards, known in the UK as Basel 3.1. This follows the first nearly final policy statement (PS17/23) published on 12 December 2023. (See our 18 January 2024 article for more detail on the first statement.)

The second policy statement focuses on the implementation of Basel 3.1 standards for credit risk and the output floor. The statement contains a thorough response to regulated firms' and industry advocacy. In most regards, the PRA continued the approach proposed in consultation paper CP16/22, thoughtfully addressing respondents' queries and arguments. In a narrower set of circumstances, the PRA proposes to amend more substantive reforms originally set out in CP16/22.

The PRA has also decided to move the implementation date by a further six months to 1 January 2026: Following a transitional period of 4 years, the Basel 3.1 standards will be fully implemented by 1 January 2030, in line with the proposals originally set out in CP16/22.

In this article, we focus on the most substantive reforms that will affect industry participants, including changes to the rules in CP16/22 addressing:

- Credit risk under the standardised approach (SA).
- Credit risk under the internal ratings-based (IRB) approach.
- Output floors.
- Adjustments to the Pillar 2 framework.
- Adjustments to the Pillar 3 framework.

## Credit Risk — Standardised Approach

### Exposure Class Allocation

In CP16/22, the PRA proposed a hierarchy for reporting based on exposure class, but did not provide explicit provisions for how to allocate exposures to the appropriate class. **The PRA has now amended its draft rules to include criteria for an exposure class hierarchy.** Where an exposure meets the criteria for multiple classes, it will follow a specific order of precedence to avoid discrepancies in risk weight application.

The new rules are designed to improve consistency of firms' allocation of exposures, resulting in capital requirements that appropriately reflect the risk of exposures. The PRA also expects providing clarity and certainty on the approach to exposure class allocation to result in more consistent calculation of capital requirements across firms.

**One of the more notable aspects of the newly proposed amendments is the increased clarity around exposures to high-risk assets**, particularly as the PRA aims to align risk-weight treatments with international standards. While the use of a


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more prescriptive hierarchy will help reduce variability, the complexity of implementation remains a concern for smaller institutions.

### External Credit Assessment Institutions (ECAIs)

Originally, the PRA suggested that firms should use nominated ECAIs consistently for all exposure types in risk management and risk-weighting.

PS9/24 retains this approach but clarifies that where an ECAI is used for general risk management purposes, that ECAI must also be used for risk-weighting purposes. To maintain a unified risk-weighting approach throughout the firm's operations, firms must ensure consistency across applications to avoid conflicting risk assessments between their external credit ratings and internal risk calculations.

**While consistent application of ECAI nominations promotes transparency, firms — particularly multinational institutions with cross-border operations — may face operational burdens in aligning these risk-weighting procedures.**

### Exposures for Off-Balance Sheet Items

The PRA proposed defining a "commitment" as any off-balance sheet contractual arrangement offered and accepted, but not yet on the balance sheet. Firms would use the revised definition to determine the point at which they need to calculate risk-weighted assets (RWAs) for commitments.

In light of industry feedback, the PRA has upheld this definition but provided further clarity on the treatment of conversion factors (CFs). CFs are used to convert off-balance sheet items into a credit equivalent amount. They represent the likelihood of the exposure coming onto the balance sheet. **The PRA has clarified that CFs will apply only to limits that have been contractually agreed upon between the firm and the obligor when calculating capital commitments under the SA. This adjustment better aligns the treatment of off-balance sheet exposures under the SA and the IRB approach.** Additionally, the PRA has indicated that HM Treasury will further refine these definitions in legislative updates to ensure consistency across frameworks.

### Exposures to Unrated Central Banks

The PRA proposed retaining the Capital Requirements Regulation's treatment of central bank exposures, assigning risk weights based on external credit ratings, with a 100% risk weight for unrated exposures.

However, following feedback, **the PRA amended the draft rules to allow firms to assign the same risk weight to an unrated central bank as they would to the associated central government.** This adjustment recognises the interdependence of central banks and their governments, creating parity in their risk profiles. This decision **marks a significant alignment with Basel 3.1's treatment of sovereign risk, further simplifying regulatory expectations for firms managing international exposures, but may nevertheless cause difficulty in some international jurisdictions.**

### Specialised Lending

Regarding specialised lending, the PRA aligned with Basel 3.1, proposing a new subclass for specialised lending with specific risk weight treatments, particularly for commodities finance, object finance and project finance. The PRA had also proposed removing the infrastructure support factor from Pillar 1.

In PS9/24, the PRA decided to amend its proposed rules governing project finance. The rules will maintain the proposal for an 80% risk weight on high-quality project finance, but PS9/24 expands the scope of eligible entities to include central banks, international organizations and multilateral development banks. **Although the infrastructure support factor was removed from Pillar 1, the PRA introduced a firm-specific structural adjustment in Pillar 2A, the "infrastructure lending adjustment," to mitigate the impact of this removal.** This adjustment aims to maintain the competitiveness and growth of infrastructure lending without increasing overall capital requirements for such exposures.

## Credit Risk — Internal Ratings-Based (IRB) Approach

### Rollout of IRB

Subject to certain exceptions, currently firms are required to roll out the IRB approach across all exposures once they have obtained an IRB permission. 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 an IRB approach for some exposure classes while allowing other exposure classes to remain permanently on the SA. While "full use" would no longer be required, the PRA proposed introducing a number of safeguards to avoid "cherry-picking" opportunities where firms are able to optimise RWAs through their choice of which exposures should remain on the SA.

The PRA proposes requiring firms to roll out the IRB approach for all exposures unless permission was granted to permanently apply the SA. Permission would only be granted by the PRA for a firm using the IRB approach to apply the SA to exposures in a rollout class if the firm could not reasonably model the exposures, or if the exposers were "immaterial." A materiality threshold of 5% of total group credit risk RWAs was proposed for determining which exposures could be classified as immaterial.

The PRA acknowledged concerns over the operational burden of this approach and **revised the materiality threshold to a cumulative 5% across all rollout classes for which firms have permission to use the IRB approach, rather than applying the threshold individually to each class.** This gives firms greater flexibility in deciding which portfolios to prioritise for IRB rollout, reducing operational complexities while maintaining the overall intent of the proposed framework.

### Infrastructure Support Factor

The PRA proposed removing the infrastructure support factor under both the SA (as discussed above under "Specialised Lending") and IRB approaches, aligning with Basel 3.1. The authority has confirmed that it will retain the removal of the infrastructure support factor under the IRB approach, but introduced the "infrastructure lending adjustment," specific to Pillar 2A firms. This adjustment prevents an increase in overall capital requirements for infrastructure exposures while allowing more risk-sensitive treatments for project finance — and ensures consistency of treatment under both the SA and IRB approaches.

### Unrecognised Exposure Adjustment

Under CP16/22, the PRA proposed a broader requirement for firms using the foundation internal ratings-based (FIRB) or advanced internal ratings-based (AIRB) approaches to calculate an unrecognised exposure adjustment for exposures that were not otherwise captured by the exposure-at-default (EAD) framework.

The PRA decided not to implement this broader approach due to concerns about operational complexity. Instead, **firms will only need to apply the unrecognised exposure adjustment to noncredit facilities subject to the AIRB approach.** This decision reduces operational burden while maintaining existing safety and soundness levels.

## Credit Risk Mitigation

### Funded Credit Protection (FCP) Securing Unfunded Credit Protection (UFCP) Obligations

The PRA initially proposed requiring that where a firm recognises both FCP and UFCP covering the same exposure, the firm should do so appropriately and in a way that does not double count the effects of the credit protection. Some respondents have argued that the proposed approach would lead to an inappropriately conservative treatment of FCPs. After considering the responses, the PRA has decided to amend its draft rules to include a decision tree for the treatment of FCP securing UFCP obligations, and added more detailed guidance in supervisory statements. **This decision tree helps firms determine when FCP securing UFCP obligations can be recognised and how it should be calculated**, providing clearer guidelines to reduce complexity in application. We expect that the simplification of FCP treatment to reduce ambiguity, but potentially present an additional operational challenge.

## Output Floor

The output floor is a key Basel 3.1 reform, intended to address shortcomings in how banks calculate their risk-weighted assets (RWAs) when using internal models. The PRA has made clear that the UK will follow Basel 3.1's approach to the output floor, meaning that **UK banks will be subject to the same minimum capital requirements based on the 72.5% output floor**.

### Calculation of the Output Floor

The PRA proposed an equation for calculating total RWAs under the output floor without adjusting for the different treatments of accounting provisions. **The PRA revised its approach by providing a new formula that includes an adjustment to account for differences between expected loss (EL) and accounting provisions**. This provides a more comparable basis for the output floor by aligning IRB and SA methodologies more closely. The new adjustment converts these differences into RWAs, simplifying the calculation process.

### Application of Output Floor to Securitisation

The PRA originally proposed including securitisation exposures in output floor calculations to ensure consistent application across firms.

The PRA received feedback expressing concern that the output floor could make securitisation uneconomic. In response, the PRA issued a consultation on the securitisation framework (DP3/23) to gather further industry input on potential adjustments to the securitisation framework in future updates. Specifically, while PS9/24 confirms the output floor's application to securitisation, the policy remains subject to further consultation and refinement before final implementation. Given the transitional period, **the securitisation-specific rules, particularly related to the output floor, may not be finalised until closer to 2026**.

### Transitional Arrangements

The PRA proposed a five-year transitional period for the output floor, beginning in January 2025.

The PRA has delayed the implementation date to January 2026 but retained the end date of December 2029 for the transitional period. The phased approach will now start at 55% in 2026, allowing firms more time to adapt while maintaining alignment with international jurisdictions.

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## Pillar 2A — Operational Risk

The PRA has introduced flexibility by reducing Pillar 2A capital add-ons based on improvements in Pillar 1 risk sensitivity. This ensures that operational risk capital requirements remain aligned with the overall risk profile of the firm without creating redundancies in capital allocations.

While firms (particularly those with lower operational risks) are likely to welcome the reduction in Pillar 2A add-ons, the PRA's cautious approach may still leave some companies with higher-than-necessary capital reserves. **While the new adjustments will provide greater flexibility, excessive capital reserves may persist for certain firms.**

## Pillar 3 — Reporting and Disclosure

In CP16/22, the PRA proposed several changes to reporting and disclosure requirements to align with Basel 3.1 standards, including enhanced disclosure requirements, standardised templates and increased reporting frequency.

In response to industry feedback, the PRA has refined the enhanced disclosure requirements to balance the need for transparency with the operational burden on firms. While the core elements of the proposed disclosures remain, the PRA has provided more detailed guidance on the specific information that needs to be disclosed, reducing ambiguity and ensuring that disclosures are meaningful and relevant.

Further, the authority has revised the frequency of reporting of certain metrics. **While the quarterly reporting requirement remains for larger institutions, smaller firms will continue to report on a semiannual or annual basis**. This adjustment acknowledges the operational challenges faced by smaller institutions and aims to reduce their reporting burden.

Lastly, the PRA has simplified some of the Pillar 3 disclosure requirements to make them more manageable for firms. This includes streamlining the information required on credit risk exposures and capital instruments.

## Conclusion

The PRA's PS9/24 represents a careful balance between aligning the UK's Basel 3.1 implementation with international standards and addressing the concerns of domestic industry participants. While the PRA has retained much of its original approach from CP16/22, the authority has made important adjustments to incorporate practitioner feedback, particularly in the areas of credit risk, output floors, and the Pillar 2 and 3 frameworks. These reforms aim to simplify implementation for firms while maintaining the integrity of the UK's financial system.

Firms will need to continue to monitor developments, especially with ongoing consultations on securitisation and operationalising these new frameworks. The phased implementation will provide some relief, but the complexities of aligning with international standards while addressing UK-specific issues will require ongoing engagement between firms and regulators.

## A Brief Update From the EU

On 19 June 2024, shortly before the PRA published PS9/24, the EU introduced a revised Capital Requirements Regulation (CRR3) and Capital Requirements Directive (CRDVI).

These amendments finalise the implementation of Basel III. CRR3 and CRDVI address, *inter alia*, implementing an output floor, revising the standardised approach to calculate RWAs and limiting the application of the IRB approach to calculate RWAs. However, the EU proposals extend beyond the strict implementation of Basel III, establishing a harmonised set of minimum rules for regulating and supervising branches of third-country credit institutions, introducing a fit and proper framework to assess the suitability of key function holders and the chief financial officer, and launching a serious of ESG-related obligations (*e.g.*, inclusion of ESG risks in the credit institution's risk management system).

**CRR3 will apply starting 1 January 2025** (with a phased-in implementation for the output floor by January 2030), and European member states must implement CRDVI by 11 January 2026. Therefore, European-based banks will need to implement the new requirements slightly ahead of UK based banks.

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