Published on *The National Law Review* https://natlawreview.com

The UK’s Banking Regulator Consults on the First Draft of Final Rules for Aspects of Basel 3.1

Article By:

Alix Prentice

The Prudential Regulation Authority ("PRA") has published its near-final policy statement (the "PS") setting out feedback to seven chapters of its consultation paper 16/22 (CP16/22) on implementation of the final elements of Basel III standards on the measurement of risk-weighted assets. The seven chapters are comprised of (1) scope and levels of application; (2) market risk; (3) credit valuation adjustment or CVA and counterparty credit risk; (4) operational risk; (5) interactions with the PRA’s Pillar 2 framework; (6) currency redenomination; and (7) the Interim Capital Regime, along with associated near-final policy material.

1. *Scope and levels of application:* These remain unchanged from those set out in CP16/22, and replicate, for Basel 3.1 implementation purposes, the existing Capital Requirements Regulation ("CRR") scope except for Interim Capital Regime ("ICR") firms and ICR consolidation entities; CRR levels of application with the exception of the output floor; and CRR provisions on prudential consolidation.
2. *Market risk:* CP16/22 proposed three new methodologies for calculating market risk, being: the simplified standardised approach or SSA; the advanced standardised approach or ASA; and the internal modelled approach or IMA. The SSA, ASA and IMA would replace existing methodologies, and are intended to improve risk sensitivity. CP16/22 also proposed a more prescriptive scope for restrictions on how firms assign positions to the trading book or non-trading book, limits on when firms can use internal hedges to transfer risks and new requirements for when firms can exempt positions used to mitigate structural foreign exchange risk.

Adjustments to the CP16/22 position in the PS include the treatment of collective investment undertakings under the ASA approach. On the IMA approach, the PRA acknowledges the inherent inconsistency with its proposals in CP16/22 to prohibit modelling of credit risk for sovereign default risk using the internal ratings based approach or IRB, and will now prohibit the modelling of sovereign exposures using the IMA for market risk.

3. *Credit valuation adjustment and counterparty credit risk:* CP16/22 proposes three new CVA capital requirements, or calculation methodologies to replace those already in place, being: the alternative approach (AA-CVA), the basic approach (BA-CVA) and the standardised approach (SA-CVA). The PS now offers an additional and optional transitional arrangement

for transactions for which existing exemptions are being removed so that those transactions can use the new CVA methodologies immediately.

4. *Operational risk:* CP16/22 proposed to replace all the existing approaches for calculating operational risk capital requirements with a single standardised approach ("SA"), and the PS is making certain amendments to exclude divested activities from the calculation of the Business Indicator or BI in the SA.
5. *Pillar 2:* While CP16/22 did not set out any policy proposals for changes to Pillar 2, it did set out the principle that capital requirements will not be double counted for the same risks in Pillars 1 and 2A. In order to address concerns about timing challenges, the PS proposes to conduct a separate review of Pillar 2A methodologies after the finalisation of its Basel 3.1 rules.
6. *Currency redenomination:* The PS maintains CP16/22's proposal to redenominate monetary values expressed in EUR and USD into GBP using average daily spot rates rounded to two significant figures.
7. *Interim capital regime:* CP16/22 deals with Small Domestic Deposit Takers which are not required to apply Basel 3.1 standards by introducing a Transitional Capital Regime or TCR that would allow these firms to remain subject to the existing CRR until a permanent tailored capital framework can be implemented. The PS leaves this approach broadly unchanged, though now named the Interim Capital Regime.

Next Steps

Q2 2024 will see the publication of a near-final policy statements with feedback to the remaining chapters of CP16/22, including on credit risk and the output floor. While final rules cannot be made until HM Treasury has first revoked the relevant parts of the CRR, the implementation date for the policy material in this PS and the subsequent publication due in Q2 remains 1 July 2025 with a transitional period of 4.5 years giving full implementation by 1 January 2030.

National Law Review, Volume XIII, Number 348