PS17/23 – Implementation of the Basel 3.1 standards

Near-final part 1 policy statement 17/23

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1: Overview

1.1 This Prudential Regulation Authority (PRA) near-final policy statement (PS) provides feedback to responses to the following chapters of consultation paper (CP) 16/22 – **Implementation of the Basel 3.1 standards**:

- Chapter 1 – Overview
- Chapter 2 – Scope and levels of application
- Chapter 6 – Market risk
- Chapter 7 – Credit valuation adjustment (CVA) and counterparty credit risk
- Chapter 8 – Operational risk
- Chapter 10 – Interactions with the PRA's Pillar 2 framework
- Chapter 13 – Currency redenomination

1.2 This near-final PS also contains the PRA's near-final policy material relevant to the above chapters, as follows:

- near-final PRA Rulebook: CRR Firms: (CRR) Instrument [2024] (Appendix 2);
- near-final statement of policy – Interpretation of EU Guidelines and Recommendations: Bank of England and PRA approach after the UK's withdrawal from the EU (Appendix 3);
- near-final amendments to supervisory statement (SS) 13/13 – Market risk[1] (Appendix 4);
- near-final amendments to SS12/13 – Counterparty credit risk[2] (Appendix 5);
- near-final PRA Rulebook: CRR Firms: SDDT Regime (Interim Capital Regime) Instrument [2024] (Appendix 6); and
- near-final statement of policy – Operating the Interim Capital Regime criteria (Appendix 7).

1.3 In Q2 2024, the PRA intends to publish a second near-final PS to provide feedback to responses to the remaining chapters of CP16/22:

- Chapter 3 – Credit risk – standardised approach (SA)
- Chapter 4 – Credit risk – internal ratings based approach (IRB)
- Chapter 5 – Credit risk mitigation
- Chapter 9 – Output floor

[1] The existing SS would continue to apply to ICR firms and ICR consolidation entities (as defined in Chapter 8 – Interim Capital Regime).
[2] The existing SS would continue to apply to ICR firms and ICR consolidation entities (as defined in Chapter 8 – Interim Capital Regime).

- Chapter 11 – Disclosure (Pillar 3)
- Chapter 12 – Reporting

1.4 The second near-final PS will contain the near-final policy material relevant to those chapters as well as feedback to responses on Pillar 2 relating to the Pillar 2A credit risk methodology, use of IRB benchmarks, and the interaction with the output floor.

1.5 The PRA has not made final rule instruments at this stage because HM Treasury (HMT) is required to first revoke the relevant parts of the **Capital Requirements Regulation (CRR)**[3] by way of statutory instrument (SI) before the PRA can replace them in the PRA rules. Once the SI has been made, the PRA intends to make all the final policy materials, rules, and technical standards in a single, final PS.

1.6 The near-final rules included in Appendix 2 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). As set out in Chapter 8 – Interim Capital Regime,[4] they do not apply to UK banks and building societies that meet the Small Domestic Deposit Taker (SDDT)[5] criteria and choose to be subject to the Interim Capital Regime (ICR) (see Appendix 6 for the near-final rules applicable to such firms).

Background

1.7 In CP16/22, the PRA set out its proposals to implement the parts of the Basel III standards that remain to be implemented in the UK. The PRA refers to them as the 'Basel 3.1 standards'. The proposals addressed the final elements of the Basel III standards concerning the measurement of risk-weighted assets (RWAs)[6] – the denominator of risk-based capital ratios. They aimed to restore the credibility of RWA calculations by improving the measurement of risk in both the internal models (IM) approaches and SAs, and the comparability of risk measurement across firms.

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[3] In this near-final PS, CRR refers to 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.
[4] The 'Interim Capital Regime' is the new name for the 'Transitional Capital Regime' (TCR) proposed in CP16/22. In this near-final PS, 'TCR' refers to proposals in CP16/22.
[5] 'Small Domestic Deposit Takers' is the new name for firms referred to as 'Simpler-regime Firms' in CP16/22. In this near-final PS, 'Simpler-regime Firms' refers to proposals in CP16/22.
[6] RWAs are an estimate of risk that determines the minimum level of regulatory capital a firm is required to maintain to deal with unexpected losses.

1.8 For the CP16/22 chapters relevant to this near-final PS, the PRA proposed the following:

- **Scope and levels of application:** to replicate the CRR scope of application, excluding Transitional Capital Regime (TCR) firms and TCR consolidation entities; replicate the CRR levels of application[7] and CRR provisions relating to prudential consolidation; and revise the definition of a Simpler-regime Firm alongside introducing the TCR to ensure eligible firms and consolidation entities do not have to implement the Basel 3.1 standards before they have the option of moving to the permanent strong and simple risk-based capital framework.

- **Market risk:** to introduce new requirements for determining which positions should be allocated to the trading book and two new approaches for calculating market risk capital requirements, which replace the existing methodologies: 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 retained and updated the existing SA as a simplified standardised approach (SSA) for firms with small or simple trading activities and retained 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.
- **CVA and counterparty credit risk:** to introduce three new approaches for calculating the CVA risk capital requirement to replace the existing methodologies: the fall-back alternative approach (AA-CVA) for firms with limited exposure to non-centrally cleared derivatives; the basic approach (BA-CVA); and the standardised approach (SA-CVA). The proposals also adjusted the calibration of the existing standardised approach for counterparty credit risk (SA-CCR) where the PRA considers it to be overly conservative, and removed certain existing exemptions from CVA capital requirements for transactions that the PRA considers have material CVA risk.
- **Operational risk:** to implement a new SA to replace the existing IM and standardised approaches. The proposals also exercised a national discretion within the international standards to remove the mechanical link between operational risk capital requirements and historic operational risk losses.
- **Currency redenomination:** to convert certain euro (EUR) and US dollar (USD) references in the international standards to pound sterling (GBP).

1.9 The PRA did not propose any policy changes with respect to its Pillar 2 framework but provided a high level description of the implications for Pillar 2 of the changes proposed to the Pillar 1 framework (see Chapter 6 – Pillar 2 for further detail).

[7] Apart from the output floor, where different levels of application were proposed in Chapter 9 of CP16/22.

Summary of responses

1.10 The PRA received formal written responses to the CP from 126 respondents. In addition, the PRA received responses through various other channels including holding over 70 meetings with stakeholders to discuss their views.

1.11 Respondents generally supported the PRA's proposals to implement the Basel 3.1 standards covered in this near-final PS. In some areas, respondents sought additional guidance and clarification on certain proposals, or provided observations related to the interaction of the proposals with the PRA's objectives and the matters to which it must have regard when making policy and rules ('have regards'). In addition, respondents requested adjustments to specific proposals in favour of treatments that they considered would be more flexible or proportionate, less operationally burdensome, or which would reduce the capital impact on firms. The substantive issues raised are addressed in detail in the relevant chapters of this near-final PS.

Changes to draft policy

1.12 When making rules, the PRA is required by the Financial Services and Markets Act 2000 (FSMA 2000) to have regard to representations made to it, and to publish an account, in general terms, of its feedback to them. Where the final rules differ from the draft in the CP in a way that the PRA considers is significant, FSMA 2000[8] requires the PRA to publish:

- details of the difference together with a cost benefit analysis (CBA); and
- a statement setting out in the PRA's opinion whether or not the impact of the final rule on mutuals is significantly different to (i) the impact that the draft rule would have had on mutuals; and (ii) the impact that the final rule will have on other PRA-authorised firms, and if so, details of the difference.

1.13 Taking into account the responses to CP16/22, the PRA has identified a number of adjustments and corrections to the draft policy where it considers them appropriate. The most material changes include:

- removing the ability for firms to receive permission to use the market risk IM for the default risk of exposures to sovereigns, to address an inconsistency between the proposed treatment of default risk of sovereigns in the credit risk and market risk frameworks (see Chapter 3 – Market risk); and
- introducing an additional, optional, transitional arrangement in the CVA risk framework for transactions for which existing exemptions from capital requirements are being removed, to provide an alternative approach for firms, which for operational reasons would find it simpler to include those transactions in the new CVA methodologies

[8] Sections 138J(5) and 138K(4) of FSMA 2000.

immediately instead of after a transitional period (see Chapter 4 – Credit valuation adjustment and counterparty credit risk).

1.14 The PRA considers the changes made to the draft policy are appropriate to reflect risks in a more proportionate manner, facilitate policy implementation, enhance the relative standing of the UK, and improve the clarity of rules in a manner that aligns with the PRA's statutory objectives. Further details on all substantive issues raised in responses, and any related amendments to the draft policy are set out in the relevant chapters of this near-final PS.

1.15 The PRA has also made a number of less substantive changes and clarifications to the draft policy, which are not described in the chapters of this near-final PS. These are reflected in the near-final PRA Rulebook: CRR Firms: (CRR) Instrument [2024] in Appendix 2. Please refer to the document titled **Comparison of Draft PRA Rulebook (CRR) Instrument [2023] against Near-final PRA Rulebook: CRR Firms (CRR) Instrument [2024]**,[9] which contains a comparison of the near-final rules with the draft rules as set out in CP16/22 for ease of identifying all of the changes made.

1.16 The PRA considers the near-final policy and rules in this near-final PS do not significantly differ overall from the draft policy and therefore the aggregated CBA presented in CP16/22 remains appropriate. Based on its latest data, the PRA estimates that the overall package of policies to implement the Basel 3.1 standards set out in CP16/22 would result in a 3.2% increase in Tier 1 capital requirements for major UK firms at the end of the transitional period on 1 January 2030. By comparison, the European Banking Authority (EBA) has estimated the latest EU proposals would increase Tier 1 minimum capital requirements for EU firms by 9.9% when fully phased-in,[10] and by 5.6% while EU-specific transitional arrangements are in place. US regulatory agencies estimate their proposals published in July 2023 would increase Common Equity Tier 1 (CET1) capital requirements for US firms by 16% for large holding companies and 9% for depository institutions at the end of their proposed transitional period.[11]

1.17 The PRA does not consider that the impact of the near-final policy and rules in this near-final PS would have a significantly different impact on mutuals relative to the impact of the draft policy and rules on mutuals, or relative to the impact of the near-final policy and rules on other PRA-authorised firms.

[9] This comparison is provided due to the exceptional nature of the Basel 3.1 package, comprising multiple changes to PRA rules, and to respond to industry feedback.
[10] European Banking Authority, September 2023, **Basel III monitoring report, Annex – analysis of EU specific adjustments**.
[11] Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, September 2023, **Basel III Notice of Proposed Rulemaking**.

Structure of the PS

1.18 This near-final PS is structured into the following chapters. The near-final rules and related policy material are included in the relevant appendices.

- Chapter 2 – Scope and levels of application
- Chapter 3 – Market risk
- Chapter 4 – Credit valuation adjustment and counterparty credit risk
- Chapter 5 – Operational risk
- Chapter 6 – Pillar 2
- Chapter 7 – Currency redenomination
- Chapter 8 – Interim Capital Regime

Accountability framework

1.19 The near-final policy and rules set out in this near-final PS 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 when making policy and rules as set out in FSMA 2000. In CP16/22, the PRA set out details of the applicable accountability framework in Appendix 6 – PRA statutory obligations and provided its assessment of relevant considerations separately in each chapter. The PRA has provided a summary of its updated overall assessment below, having taken into account consultation responses. More detailed updated explanations are included in the relevant chapters of this near-final PS, where the PRA has made changes to the draft policy.

1.20 The PRA considers that the near-final policy and rules in this near-final PS will advance its primary objective to promote the safety and soundness of the firms it regulates. They address shortcomings in the RWA framework that were revealed by the global financial crisis, including inadequate Pillar 1 capital requirements in some areas, and a 'worrying degree of variability' in the calculation of risk weights noted by the Basel Committee on Banking Supervision (BCBS) in December 2017.[12] Addressing these shortcomings is important to underpin confidence that firms are adequately capitalised given the risks to which they are exposed, which in turn supports financial stability. In particular:

- improving the risk-sensitivity of the SAs for market risk, operational risk, and CVA risk, in addition to targeted adjustments to the calibration of SA-CCR, should result in RWAs that are more reflective of risk for firms using those approaches; and
- constraining the use of IM approaches where RWAs cannot be modelled in a robust and prudent manner (including completely removing such approaches in the case of CVA and operational risk) should reduce unwarranted RWA variability across firms.

[12] BCBS – **Basel III: Finalising post-crisis reforms**.

1.21 The near-final policy and rules in this near-final PS will also advance the PRA's secondary objective to facilitate effective competition by:

- promoting a more level playing field between firms through reducing the potential competitive advantage firms using IM approaches currently have relative to firms using SAs, and increasing the consistency in RWA approaches across firms;
- reducing barriers to entry for smaller firms to use IMs for market risk by allowing model permission to be granted at the trading desk level rather than for the entire trading book portfolio; and
- providing greater proportionality through simpler, less burdensome alternatives for smaller and less complex firms with limited trading activity, such as the simplified SA for market risk and the fall-back alternative approach for CVA risk.

1.22 Changes to the PRA's accountability framework related to international competitiveness and growth subject to alignment with international standards under the **Financial Services and Markets Act 2023** (FSMA 2023) do not apply to the near-final policy and rules in this near-final PS. These provisions are disapplied by regulation 4 of the **FSMA 2023 (Commencement No. 2 and Transitional Provisions) Regulations 2023**. Nevertheless, as the PRA noted in CP16/22, international competitiveness and growth considerations and alignment with international standards still apply as part of the factors the PRA must 'have regard' to, and they were among the most significant of those factors in developing the policy and rules. The 'have regard' factors that the PRA considered to be the most significant in developing the policy and rules in this near-final PS, including the amendments made to the proposals in CP16/22, were **relevant international standards**, **international competitiveness**, and **the relative standing of the UK as a place for internationally active firms to operate.**

1.23 In considering these 'have regards' and the characteristics of the UK's financial system, the proposals in CP16/22 included limited adjustments to international standards to better capture risk and support the international competitiveness of the UK. Adjustments included, for example, lowering the calibration of aspects of the SA-CCR and CVA frameworks and introducing more flexible approaches to certain asset classes within the market risk framework. The changes to the draft policy included in this near-final PS go further in supporting the international competitiveness of the UK, for example, through additional adjustments to align market risk capital requirements more closely for sovereign exposures with those of other major jurisdictions and greater flexibility in transitional provisions for the CVA framework.

1.24 Although the PRA has made further limited changes to the proposals in CP16/22, it considers that the near-final policy and rules in this near-final PS still align with international standards, particularly in view of the removal of existing deviations from international standards including the exemptions from CVA capital requirements for exposures to sovereigns, non-financial counterparties, and pension funds. Alignment with international standards in turn supports the UK's international competitiveness, including the relative standing of the UK as a global financial centre, by:

- strengthening key stakeholders' confidence in the UK banking system by addressing a widespread and long-standing concern around a core plank of banking regulation – the credibility in the calculation of RWAs;
- assuring regulators in other jurisdictions of UK authorities' commitment to robust standards, which allows for such deep interconnections between the financial systems of their jurisdictions and the UK;
- facilitating the operations of international groups spanning multiple jurisdictions by helping to ensure they do not have to follow different regimes in different jurisdictions; and
- providing stability and predictability to financial firms and other stakeholders through the implementation of internationally aligned standards, which promotes a high-trust environment in the UK where firms and stakeholders can confidently conduct their business over the medium term.

1.25 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 the sector are sufficiently robust to withstand economic shocks and can therefore maintain lending to the real economy during downturns.

1.26 In addition to the assessment above and in the chapters of this near-final PS, the PRA is required to publish a summary of the purpose of the rules, CRR restatement provisions, and CRR corresponding provisions.[13] The PRA intends to publish a single summary and statements covering the Basel 3.1 standards package as part of the second near-final PS.

Implementation and next steps

1.27 The policy material in this near-final PS is published as near-final. The PRA does not intend to change the policy or make substantive alterations to the instruments before the making of the final policy material. This will also be the case for the policy material in the second near-final PS that the PRA intends to publish in Q2 2024, covering the remaining chapters of CP16/22 not addressed in this near-final PS.

1.28 The PRA intends to publish the final rule instruments, technical standards instrument, and policy in a single subsequent final PS covering the entire Basel 3.1 package, once HMT has made the SI to revoke the relevant parts of the CRR that the final PRA rules will replace.

[13] Sections 144D(2) and 144E(3) of FSMA 2000 and section 5(4) of the Financial Services Act 2021.

1.29 In CP16/22, the PRA consulted on an implementation date of 1 January 2025, with a five-year transitional period. The PRA received five responses relating to the proposed implementation date. All five respondents requested the PRA publish its final rules for implementing the Basel 3.1 standards sufficiently in advance of the implementation date to allow firms to robustly complete their implementation efforts. Three respondents provided estimates on the minimum period required to implement following the publication of near-final rules, suggesting a minimum period of 12 months would be necessary for a robust implementation.

1.30 The PRA has considered the responses received alongside the implementation timelines of other major jurisdictions and has decided to move the proposed implementation date for the Basel 3.1 standards by six months to Tuesday 1 July 2025. As such, the policy that will be published in the final PS is intended to take effect from that date, which will be aligned with the date of HMT's revocation of the relevant parts of the CRR. To ensure full implementation occurs by 1 January 2030, in line with the end-date of the transitional period in the proposals set out in CP16/22, the PRA has reduced the transitional period to 4.5 years.[14]

1.31 Any references related to the UK's membership of the EU in the supervisory statements and statements of policy covered by the near-final policy in this near-final PS will be updated as part of the final PS to reflect the UK's withdrawal from the EU. Unless otherwise stated, any remaining references to EU or EU-derived legislation are to the version of that legislation which forms part of retained EU law in the UK.[15]

[14] In CP16/22, the PRA proposed transitional arrangements for the output floor and aspects of the CVA and CCR framework which would have increased capital requirements in five annual steps between 1 January 2025 and 1 January 2030. The PRA's revised transitional period means that the first step would differ from that in CP16/22, lasting for six months from 1 July 2025 to 1 January 2026 (rather than for one year between 1 January 2025 to 1 January 2026). The subsequent four steps would then continue from 1 January 2026 to 1 January 2030 as proposed in CP16/22.

[15] For further information please see **Transitioning to post-exit rules and standards**.

2: Scope and levels of application

2.1 This chapter provides feedback to responses to Chapter 2 of consultation paper (CP) 16/22 – **Implementation of the Basel 3.1 standards**, which set out the proposed scope and levels of application for implementing the Basel 3.1 standards. This chapter also sets out the Prudential Regulation Authority's (PRA) near-final policy on scope and levels of application following the consultation.

2.2 In CP16/22, the PRA proposed to:

- replicate the Capital Requirements Regulation (CRR)[16] scope of application for the purposes of implementing the Basel 3.1 standards, except for Interim Capital Regime (ICR) firms and ICR consolidation entities;
- replicate 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 were proposed in Chapter 9 of CP16/22); and
- replicate the effect of CRR provisions relating to prudential consolidation for the purposes of implementing the Basel 3.1 standards.

2.3 Chapter 2 of CP16/22 also set out proposals relating to Small Domestic Deposit Takers (SDDT) and the ICR. The PRA's near-final policy for those proposals is set out in Chapter 8 – Interim Capital Regime. The PRA's near-final policy on the output floor, including its level of application, will be published in the second near-final policy statement (PS) intended to be published in Q2 2024 as outlined in paragraph 1.3.

2.4 The PRA received one response to its proposals on scope and levels of application. However, the response related to broader concerns about the appropriate level of application of all PRA rules and the CRR, rather than the specific proposals in CP16/22. The response cannot be addressed as part of this near-final PS, because it relates to a broader set of rules and legislation, which are not being amended as part of the Basel 3.1 implementation. Consequently, the PRA has decided to make no changes to its policy as proposed in CP16/22. The PRA considers its analysis of its objectives and 'have regards', as presented in Chapter 2 of CP16/22 remains appropriate.

2.5 The PRA's near-final policy on scope and levels of application, as set out in CP16/22 and also in paragraph 2.2 above, applies to the following new parts of the PRA Rulebook covered in this near-final PS:

- Market Risk: General Provisions (CRR)

[16] In this near-final PS, CRR refers to 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.

- Market Risk: Internal Model Approach (CRR)
- Market Risk: Advanced Standardised Approach (CRR)
- Market Risk: Simplified Standardised Approach (CRR)
- Credit Valuation Adjustment Risk
- Operational Risk

3: Market risk

Introduction

3.1 This chapter provides feedback to responses to Chapter 6 of consultation paper (CP) 16/22 – **Implementation of the Basel 3.1 standards**, which set out proposals to implement the Basel 3.1 standards for market risk. This chapter also sets out the Prudential Regulation Authority's (PRA) near-final policy on market risk following the consultation.

3.2 In CP16/22, the PRA proposed to implement the Basel 3.1 market risk framework, comprising three new methodologies: the simplified standardised approach (SSA); the advanced standardised approach (ASA); and the internal modelled approach (IMA). The new framework would replace the existing calculation methodologies and improve the risk sensitivity of market risk capital requirements. It included the following improvements compared to the existing approaches:

- a clearer definition of the scope of application of the framework, through a stricter delineation between positions that should be allocated to the trading book and non-trading book, and a specified treatment of internal hedges between the two books;
- improved methodologies for estimating market risk, including a more comprehensive standardised approach and a modelled approach that incorporates additional risk factors such as the liquidity of traded positions; and
- improved proportionality through the retention of a recalibrated version of the existing standardised approach as a simplified alternative for firms with a limited amount of derivatives activity.

3.3 The PRA received 18 responses to the market risk proposals. The respondents were generally supportive of the overall approach, including its alignment with international standards. There were no substantive comments on the proposals to implement the SSA. Comments focused on:

- the scope of the trading book and treatment of internal hedges between it and the non-trading book;
- the treatment of exposures to collective investment undertakings (CIUs), carbon emission certificates, and the scope of the residual risk add-on in the ASA; and
- clarifications related to elements of the IMA, including requirements related to the expected shortfall model, the floor on the probability of default (PD) in the default risk model, and technical aspects of the non-modellable risk factors framework.

3.4 In considering the responses to the consultation, the PRA has decided to amend the draft rules in certain areas. This chapter describes the comments and amendments that the PRA considers are more material. As described in Chapter 1 – Overview, the PRA has also made a number of less material amendments and clarifications to the draft rules, which are not described in this chapter. These amendments are reflected in the near-final PRA Rulebook: CRR Firms: (CRR) Instrument 2024 in Appendix 2. Please refer to the document titled **Comparison of Draft PRA Rulebook (CRR) Instrument [2023] against Near-final PRA Rulebook: CRR Firms (CRR) Instrument [2024]**,[17] which contains a comparison of the near-final rules with the draft rules as set out in CP16/22 for ease of identifying all of the changes made.

3.5 The appendices to this near-final policy statement contain the PRA's near-final policy, which will:

- amend the existing Trading Book (CRR) Part of the PRA Rulebook (Appendix 2);
- introduce a new Market Risk: Simplified Standardised Approach (CRR) Part of the PRA Rulebook (Appendix 2);
- introduce a new Market Risk: General Provisions (CRR) Part of the PRA Rulebook (Appendix 2);
- introduce a new Market Risk: Advanced Standardised Approach (CRR) Part of the PRA Rulebook (Appendix 2);
- introduce a new Market Risk: Internal Model Approach (CRR) Part of the PRA Rulebook (Appendix 2);
- 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 (Appendix 2); and
- amend supervisory statement (SS) 13/13 – Market risk (Appendix 4).

3.6 To provide greater clarity and transparency on the approvals process, the PRA has also updated the **Permissions (CRR firms)** webpage with documents setting out the format and content of the supporting information expected for Permissions applications to use the new IMA and specific derogations to the ASA.

3.7 The sections below have been structured broadly along the same lines as Chapter 6 of CP16/22, covering the main areas where the PRA received comments from respondents as follows:

- scope of application;
- advanced standardised approach; and
- internal model approach.

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[17] This comparison is provided due to the exceptional nature of the Basel 3.1 package, comprising multiple changes to PRA rules, and to respond to industry feedback.

Scope of application

3.8 The PRA proposed to introduce new, more prescriptive requirements that determine the scope of positions to which the market risk framework would apply, including:

- restrictions on how firms assign positions to the trading book or non-trading book (which determines whether a position is subject to the market risk or credit risk frameworks respectively);
- limits on when a firm can use internal hedges to transfer risks between the market, credit, and credit valuation adjustment (CVA) risk frameworks; and
- new requirements related to when firms can exempt positions used to mitigate structural foreign exchange (SFX) risk from market risk capital requirements.

3.9 The PRA received seven responses to this section of the CP. The substantive issues raised by respondents related to the assignment of positions to the trading book or non-trading book, the recognition of internal hedges, and a number of technical clarifications as set out below.

Assignment of positions to the trading or non-trading book and recognition of internal hedges

3.10 The PRA proposed to align with the Basel 3.1 standards by introducing new objective requirements to support a more consistent assignment of positions to the trading book or non-trading book. The requirements included safeguards to limit the ability of firms to move positions or related risks between frameworks after initial assignment.

- There would be limits on the ability of firms to move risks between frameworks (eg from the market risk framework to the credit risk framework) through internal hedges. The proposed rules only permitted credit and equity internal hedges between the trading book and banking book to be recognised in the credit risk framework if they were exactly matched by a set of trading book positions with external third parties. Internal credit hedges would be required to meet the credit risk mitigation (CRM) rules on eligible unfunded credit protection.
- Firms would be required to treat any arm’s-length sale between the trading book and non-trading book as a reassignment, meaning that they would be required to maintain a capital add-on equal to any resulting reduction in capital requirements until the position matured or expired.

3.11 With respect to internal credit and equity hedges, two respondents raised concerns that the proposals were too restrictive in determining what constitutes an ‘exact match’ to a set of positions with external third parties. Two respondents also noted that the requirement for credit and equity hedges to be externalised by entering into exactly matching positions with external third parties would increase costs. One respondent argued that restricting internal credit hedges to those that qualify as eligible unfunded credit protection under the CRM rules would be too restrictive, and in their interpretation would mean credit-linked notes would not be eligible.

3.12 With respect to the treatment of arm's-length sales between the trading book and non-trading book, three respondents argued that the requirement to treat them as a reassignment and therefore subject to a capital add-on was too conservative and should be removed.

3.13 Having considered the responses to the proposals on internal hedges, the PRA has decided to make no changes to the draft policy and rules. In meeting the 'exact match' requirements, firms are permitted to enter into more than one trade to facilitate the exact matching of the internal hedge. The PRA considers that this provides sufficient flexibility for the requirement to be applied. The requirements on the externalisation of trades are important new elements of the boundary between the trading book and non-trading book: a strong boundary is key to preventing arbitrage between capital requirements in different frameworks. The requirements ensure that risks can only be moved across frameworks in cases where the trading book is, in effect, simply facilitating the process of entering the relevant hedging transaction. Similarly, the PRA has retained the requirement that arm's-length sales are treated as reassignments to maintain a strong boundary between the trading and non-trading books.

3.14 Regarding the eligibility of credit-linked notes as internal hedges for credit risk, the PRA notes that these are considered unfunded credit risk mitigation and therefore can be recognised as internal hedges under the proposal (provided they meet the CRM requirements).

Other technical issues

3.15 Other material responses to this section of CP16/22 focused on three technical clarifications:

- **Treatment of non-trading book foreign exchange (FX) and commodity positions:** one respondent requested clarification that non-trading book FX and commodity positions may be combined with trading book positions when calculating market risk capital requirements. The PRA has clarified that FX and commodity positions in the non-trading book are not required to be treated separately to trading book FX or commodity positions for the purpose of market risk calculations. The PRA considers that the clarification removes any ambiguity in the rules, and so should improve consistency of implementation.
- **Consolidated capital requirements for market risk:** One respondent requested clarification of how to calculate consolidated capital requirements when group entities have internal model permission for some but not all trading desks, and/or where group entities have a separate interest rate risk hedging desk to hold interest rate risk

transferred from the banking book (as required by the proposed PRA draft rule). The PRA has clarified that capital requirements for the interest rate risk hedging desk should be treated separately to capital requirements for the remaining positions when calculating consolidated capital requirements. For those remaining positions, as is the case under the existing requirements, the approach to consolidation depends on whether a firm has permission to combine positions across entities. The PRA considers that the additional clarifications improve transparency and should lead to consistent implementation.

- **Treatment of certain CIUs that are also listed:** Three respondents requested that the PRA clarify that certain publicly listed and traded closed-ended funds are treated as listed equities rather than CIUs. The PRA has clarified that certain closed-ended listed CIUs should be treated as stand-alone listed equities for the purpose of calculating market risk capital requirements. The UK regulatory framework permits certain CIUs to trade on exchange, subject to certain conditions.[18] Given this context, the products have similar characteristics to equities – investors make an initial investment, the entity invests those funds, and investors can buy and sell their position via the exchange rather than redeeming from the fund itself. The PRA acknowledges that the draft policy and rules were ambiguous on whether these types of investments should be considered equities or CIUs. This clarification should ensure consistent treatment of these products in a way that recognises that their risk characteristics are most closely aligned with equities.

PRA objectives and 'have regards' analysis

3.16 The near-final rules on scope of application, incorporating the clarifications above on consolidated capital requirements and the treatment of FX, commodity, and certain CIU positions, are materially aligned with those in CP16/22 and therefore the PRA considers its analysis of its objectives and have regards in CP16/22 remains appropriate.

Advanced standardised approach

3.17 The PRA proposed to introduce the Basel 3.1 standards' ASA. The ASA capital requirements are calculated as the sum of three elements:

- the Sensitivities-based Method (SbM);
- the residual risk add-on (RRAO); and
- the default risk charge (DRC).

The PRA proposed several targeted adjustments to reflect the UK market. These included:

- an additional calculation approach for positions in CIUs;

[18] FCA Handbook – Chapter 15 of Listing Rules.

- an adjustment to the treatment of exposures to carbon emissions trading schemes; and
- clarification of the calculation of gross jump-to-default in the DRC.

3.18 The PRA received eleven responses to the ASA proposals. Respondents were generally supportive of the package. The substantive comments received related to CIU calculations, the treatment of commodity exposures and technical aspects of the RRAO.

Treatment of collective investment undertakings

3.19 Under the PRA's proposals for the treatment of CIUs, ASA capital requirements could be calculated using one of four approaches:

- the look-through approach (LTA), under which firms, if they know the exact holdings of the CIU, would 'look through' to the underlying positions and treat them as if those positions were on the firm's own balance sheet;
- the mandate-based approach (MBA), under which firms would calculate their exposure by assuming that the CIU invests in a portfolio consistent with its mandate that generates the maximum possible capital requirement;
- the external party approach (EPA), where firms can instead use a risk weight calculated by an eligible third party; or
- the fallback approach (FBA), under which firms that do not use any of the above approaches would apply a risk weight of 70%.

3.20 The PRA proposed to introduce the EPA, which is not included in the Basel 3.1 standards, to make it operationally easier for firms to calculate CIU capital requirements without having to apply the FBA. Respondents supported the introduction of the EPA, but raised the following issues and areas for clarification:

- seven respondents argued that the scope of eligible third parties for the EPA was too restrictive, and in particular that third-party data vendors should be eligible in addition to the CIU management company or its depository financial institutions;
- three respondents argued that it was overly conservative for the FBA and EPA to require capital requirements for the CIU to be calculated with no diversification benefit with any other positions in the firm's trading portfolio; and
- three respondents requested a clarification on how the EPA should be applied for the purpose of calculating the DRC and RRAO requirements.

3.21 Having considered the responses, the PRA has decided to make amendments to its draft rules to:

- expand the range of eligible third parties for the EPA, subject to validation of the accuracy of their data by an external auditor. The PRA considers that this amendment would ease the operational burden for firms using the EPA, while ensuring the relevant third parties are subject to appropriate quality controls (and therefore maintaining the robustness of the outcome of the approach); and

- clarify that firms using the EPA should obtain separate risk weights for the SbM, DRC, and RRAO elements of the ASA from eligible third parties. This clarification should ensure consistent application of the EPA across firms and is in line with the intent of the proposals.

3.22 However, the PRA has decided to retain its draft policy requiring capital requirements for exposures to CIUs to be calculated on a stand-alone basis under the EPA and FBA. These approaches are only applied when the investors in the funds have limited information about the fund holdings. The PRA considers it would not be appropriate from a safety and soundness perspective to allow diversification with other positions, given the lack of information about fund holdings and the diversity of risks across CIUs.

Treatment of carbon emission certificates and other commodity exposures

3.23 The PRA proposal specified twelve risk buckets and corresponding risk weights for firms' exposures to commodity risk factors. This structure was aligned with the Basel 3.1 standards, with the exception that for exposures to carbon emissions certificates, the PRA included an additional separate risk bucket. The calibration in the proposal would result in an identical outcome to the Basel 3.1 standards, but by having a separate bucket for carbon emissions certificates, it would be simpler to update the calibration as carbon markets evolve. The PRA requested additional information that could be considered to assess the appropriateness of the proposed calibration, particularly in a period of stress.

3.24 Respondents generally supported the proposed separate risk bucket for carbon emission certificates. Seven respondents suggested that reduced risk weights and higher correlations for carbon emissions certificates could already be justified based on recent historical data. Two respondents argued that a further adjustment should be made to the commodity treatment – they suggested that exposures to electricity and gaseous combustibles should be combined into a single bucket with an increased intra-bucket correlation and lower risk weight.

3.25 After considering the responses, the PRA has decided to retain the proposed treatment of carbon emission certificates. The PRA has assessed the historical price data for carbon emission certificates provided by respondents but considered that at this stage they are insufficient to assess how markets might behave in a stress period. The PRA notes that pricing in historical periods observed to date has also been affected by evolving environmental policies domestically and internationally, making it challenging to assess whether a lower calibration is justified. The PRA will however continue to evaluate the appropriate calibration of these exposures as markets develop.

3.26 With respect to electricity and gaseous combustibles, respondents suggested that prices in forward markets may be more appropriate for estimating risk weights than spot prices given that exposures of many market participants stem from long- to medium-term hedges. The PRA considers that it is important for safety and soundness purposes that risk weights are appropriate for the range of exposures firms may hold. While some firms may have longer tenor positions, for those that do not, and are therefore exposed to the more volatile spot market, there would be a risk of inappropriately low capital requirements if risk weights were based on forward prices. As a result, the PRA has decided to retain its proposed treatment.

The residual risk add-on

3.27 The PRA proposed a RRAO, aligned with the Basel 3.1 standards, to calculate capital requirements for complex or exotic risks not captured by the SbM or DRC. To support consistent implementation, the PRA's draft rules included a non-exhaustive list of positions deemed to have exotic underlyings, or other residual risks that would fall in scope of the RRAO.

3.28 Respondents supported the inclusion of the RRAO in the proposal. However, four respondents argued that exactly matching 'back-to-back' transactions that would be in scope of the RRAO should be permitted to be offset and therefore excluded from the RRAO. Additionally, four respondents suggested that Constant Maturity Swap (CMS) spread options should not be in the scope of RRAO. They argued that although the instruments had risks that are not captured by the SbM or DRC, the resulting RRAO capital requirement was unnecessarily conservative for those risks.

3.29 Having considered the responses, the PRA has clarified that exactly matching back-to-back transactions can be excluded from the RRAO requirement. This clarification recognises that in these cases there is no residual risk that requires a capital requirement. This approach is aligned with the Basel 3.1 standards. However, the PRA has decided not to exclude CMS options from the RRAO. As respondents acknowledged, CMS options contain correlation risk. This risk is not addressed by the SbM or DRC. Excluding CMS options from the RRAO would therefore lead to risks from CMS options, which can be material, not being capitalised. The PRA considers that such an outcome would be inconsistent with the PRA's primary safety and soundness objective.

PRA objectives and 'have regards' analysis

3.30 The near-final rules, incorporating the clarifications for the RRAO and treatment of CIUs above, and the expansion of eligible third parties for the EPA calculation, are materially consistent with those in CP16/22 and therefore the PRA considers its analysis of its objectives and have regards in CP16/22 remains appropriate.

Internal model approach

3.31 The PRA proposed to implement the new Basel 3.1 market risk IMA. The market risk capital requirement under the new IMA would be the sum of four components:

- an expected shortfall (ES)-based requirement;
- a default risk requirement (IMA-DRC);
- a non-modellable risk factors (NMRFs) requirement; and
- a separate capital requirement based on a ‘risks not in model’ (RNIM) framework.

3.32 Use of the new IMA would be subject to permission, granted at the level of a firm’s individual trading desks. The new framework would also introduce minimum requirements defining the structure and eligibility of trading desks to use the IMA.

3.33 The PRA received nine responses to the proposals on the IMA. Respondents were generally supportive of the new approach, noting that the PRA had included a more proportionate treatment of CIU positions than under the Basel 3.1 standards and a more risk-sensitive approach to the recognition of NMRFs when performing back-testing on internal models. However, a number of respondents provided comments on specific elements of the proposals as described below.

Expected shortfall – calibration and profit and loss attribution test

3.34 The PRA proposed to implement the Basel 3.1 standards for the ES model in the IMA. In particular, the proposals included:

- Minimum standards for the design and calibration of the ES model, which permitted some flexibility in how the model is calibrated to a stressed period. Firms could use a subset of risk factors to calculate risk in a stressed period, provided those risk factors explain 75% of the variation of the fully-specified ES model.
- Two tests of the ES model’s accuracy and conservatism that must be continually passed for the model to be used for capital requirements: the ‘profit and loss attribution test’ (PLAT), and back-testing. The PLAT is a new test designed to assess whether the ES model is accurately capturing all material risks that affect the value of the portfolio it is modelling. Back-testing is an approach that exists under the current framework and would continue under the new approach. It compares actual portfolio performance against that estimated by the model to assess whether the model is sufficiently conservative.

3.35 The proposals set out the consequences for failing the PLAT. Under the PLAT, desks would be classified as green, yellow, orange, or red:

- **Green trading desks** have fully passed the PLAT and the ES model can be used to calculate capital requirements without adjustment.
- **Yellow trading desks** are previously green desks whose model performance has deteriorated within specified thresholds. These desks can use the ES model but with a specified capital add-on.
- **Orange trading desks** are desks that previously fell below the lowest threshold of the PLAT, meaning they have previously been in the red zone, but are now back in the yellow zone. Their performance has improved but they have not achieved green status again and are not permitted to be used for capital requirements until green status is achieved. Firms must use the ASA for these desks.
- **Red trading desks** are those with a model that has performed below the lowest threshold of the PLAT. Firms must use the ASA for these desks.

3.36 Respondents raised the following issues:

- Four respondents requested that the 75% minimum coverage requirement for the subset of risk factors used to calibrate the model to a stress period only apply at the overall portfolio level, not for each individual trading desk. They noted that this amendment would reduce the burden and align with the Basel 3.1 standards. They also requested that the consequence of failing to meet this requirement – having to calculate capital requirements under the ASA – should apply after one month, rather than the proposed two weeks.
- Two respondents requested the PRA take a less conservative approach for trading desks that have been in the red zone for the PLAT, by allowing firms to use the IMA for orange trading desks.

3.37 Having considered the responses, the PRA has decided to amend the draft rules to apply the 75% minimum coverage requirement for risk factors used to calibrate the model at the overall portfolio level only. This would be consistent with the requirement to calibrate models to a stress period that is appropriate at the overall portfolio level. The rule has also been amended such that the consequences for failing to meet the 75% minimum coverage requirement would only apply after one month. The PRA considers that these adjustments make the approach more proportionate and operationally easier, without reducing the prudence of the outcome.

3.38 However, the PRA has decided to retain the consequences of failing the PLAT as in the draft rules. The PLAT is designed to assess whether firms' models accurately reflect risk. The framework provides some flexibility in cases where performance of trading desks may mildly deteriorate, subject to having already met the minimum accuracy requirements (yellow trading desks). Where a desk's model has previously performed at a level that did not meet the minimum PLAT threshold, there is clear evidence that it does not accurately reflect risks. Therefore, the PRA considers that it is important for safety and soundness purposes that the model be required to fully pass the PLAT before it can be used as the basis for capital requirements again.

Default risk charge – treatment of sovereign exposures

3.39 The PRA proposed to implement the Basel 3.1 standards' IMA-DRC to set capital requirements for default risk associated with certain exposures. The IMA-DRC is designed to broadly align with the calibration of default risk capital requirements in the credit risk internal ratings based (IRB) approach. The Basel 3.1 standards require all positions with default risk to be included in the model if the relevant trading desk has IMA permission. They also specify a number of model parameters including a 3 basis points floor to the PD for all exposures.

3.40 Five respondents noted an inconsistency with the PRA's proposals in CP16/22 for credit risk. In CP16/22, the PRA proposed to prohibit modelling of sovereign default risk under IRB, and to instead require all central government and central bank exposures to be risk-weighted under the credit risk standardised approach due to the limited availability of default data. Respondents noted that the resulting capital requirement under the credit risk standardised approach would be substantially lower than under the IMA-DRC, given the proposed 3 basis points PD floor in the IMA-DRC. Respondents argued that the PD floor was overly conservative for sovereigns and provided supporting evidence. They also noted that IMA-DRC capital requirements for sovereigns would be substantially higher than under the ASA given that approach is closely linked to the credit risk standardised approach. Respondents therefore requested the PRA improve the consistency in the treatment of sovereign default risk across the capital framework, for example by removing the PD floor for sovereign exposures in the IMA-DRC.

3.41 Having considered the responses, the PRA acknowledges that the challenges in appropriately modelling sovereign default risk apply equally to the credit risk and market risk frameworks, and that there could be substantive inconsistencies in capital requirements between IMA, ASA, and the credit risk framework in the draft rules. Therefore, to improve consistency without weakening the IMA-DRC approach by adjusting the PD floor, the PRA has amended the draft rules for market risk to reflect a consistent approach based on the proposed treatment of sovereign exposures in the credit risk framework – central government and central bank exposures will not be permitted to be modelled in the IMA-DRC.[19] Where firms have permission to use the IMA for trading desks containing sovereign exposures not eligible for IMA-DRC under the amended rules, they would be required to use the ASA for those exposures, but would continue to apply the other IMA components (namely ES, NMRFs and RNIMs).

3.42 The PRA considers the amended approach improves the coherence of the framework and supports safety and soundness by preventing the modelling of risks where there are

[19] The PRA is not providing feedback relating to the proposed credit risk framework in this near-final PS. As noted in the Overview chapter, the PRA intends to publish a second near-final PS in Q2 2024.

insufficient data. The amendment would also reduce arbitrage opportunities across frameworks and approaches, and is in line with the intention of the default risk element of the new market risk framework to align the credit risk and market risk treatment of the same types of risk.

Data quality standards for non-modellable risk factors

3.43 To align with the Basel 3.1 standards, in CP16/22, the PRA proposed to permit risk factors to be included in firms' ES models only where those risk factors met minimum quantitative and qualitative criteria related to the number of observable data points. Firms would map risk factors to verifiable, observable prices from which they can derive the value of the risk factor, to demonstrate that they had a sufficient number of observations to calibrate the ES model. They would also be required to have a sound methodology to derive the value of the risk factors from those observed prices. In cases where more than one risk factor would be derived from a single observable price, the draft rule required that the methodology for extracting one risk factor should not depend on the value of other risk factors being extracted from that price. Risk factors not meeting all criteria would be NMRFs, be excluded from the ES model, and have a separate capital requirement.

3.44 Risk factors related to more complex instruments are often defined based on a number of dimensions (eg for an option, the value of a risk factor might depend on both the maturity of the option and its moneyness). In these cases, firms would be required to split each dimension into buckets and assess the number of observable prices in each bucket. The PRA's draft rules defined regulatory buckets that firms could use for this purpose, but proposed that firms may elect to choose either the regulatory-defined buckets or firm-defined buckets. However, they would be required to use the same approach for all dimensions (eg a firm must use the regulatory-defined bucket for the moneyness dimension if it elects to use the regulatory-defined bucket for the maturity dimension).

3.45 One respondent argued that the data quality standards were disproportionate and could favour firms with greater access to trading data, for example those with significant trading activities. Eight respondents also requested clarifications and additional flexibility in certain areas. In particular:

- Respondents argued that the requirement that the methodology to derive the value of a risk factor from an observable price without any dependence on the value of other risk factors being derived from the same price is complex, disproportionate, and more restrictive than the Basel 3.1 standards. Respondents asked the PRA to align with Basel 3.1 standards by allowing more than one risk factor to be extracted from a verifiable price, even in cases where the methodology depends on the value of other risk factors.
- Respondents noted that requiring firms to use the same approach for bucketing all dimensions of a risk factor (ie regulatory or firm-defined buckets) could have a knock-

on effect on the ability of a model to pass the PLAT. The PLAT requires firms to use the same buckets to define risk factors as for the NMRF framework. More granular buckets provide more granular risk factors to ensure the model is sufficiently accurate to pass the PLAT. But buckets that are too granular could pose challenges to identifying a sufficient number of observable prices for each risk factor. Some dimensions may benefit from less granular buckets than those defined in the rules for the purpose of the NMRF framework. Respondents asked the PRA to amend the draft rules, so that firms can separately choose to use either regulatory- or firm-defined buckets for each dimension of a risk factor.

3.46 The PRA considers that sufficiently comprehensive and accurate data are essential to model exposures. Allowing firms to model risks in cases where there are insufficient data or model performance is poor would be inconsistent with the PRA's safety and soundness objective. While the PRA understands that firms will have different access to data, it is appropriate that those permitted to use models to calculate capital requirements meet common minimum standards. However, the PRA acknowledges that some clarifications and minor technical changes would improve access to modelling, without undermining the PRA's primary safety and soundness objective. The PRA has amended the draft rules and related expectations in SS13/13 to provide additional flexibility in two key areas related to the above responses:

- To provide increased flexibility in how firms may use a single price observation to derive multiple risk factors. The amendments permit that the methodology may depend on the value of other risk factors derived from the price. The PRA will continue to expect firms to undertake quantitative assessments to demonstrate a close relationship between the observable price and the risk factors derived from it.
- To allow firms to make different choices of whether to use the regulatory buckets or firm-defined buckets for each dimension of a risk factor for the purpose of the NMRF framework. The amended rules would not however permit firms to use a combination of both approaches on a single dimension.

3.47 The PRA considers that reducing restrictions on allowing more than one risk factor value to be extracted from a price observation provides a less burdensome approach that remains prudent, given the requirement for firms to demonstrate a close relationship between the price and risk factors derived from it. It would also align with the Basel 3.1 standards and better reflect industry practice. The PRA also considers allowing firms to use either regulatory buckets or own buckets where there are multiple dimensions, providing flexibility that strikes an appropriate balance enabling firms to meet NMRF tests and the PLAT.

Capital requirements for NMRFs

3.48 In CP16/22, the PRA proposed to introduce a methodology to calculate capital requirements for NMRFs, aligned with the Basel 3.1 standards. The approach would require firms to calculate capital requirements for each NMRF based on the losses they could cause in a stress scenario. Where a firm cannot develop a satisfactory stress scenario for an NMRF, the Basel 3.1 standards' fall-back approach requires firms to use the maximum possible losses. To clarify the approach in situations where an NMRF has a theoretically infinite maximum loss, the PRA set out a fall-back approach that permitted the use of judgement, but floored the resulting capital requirement at the maximum historically observed loss for that NMRF.

3.49 One respondent argued that the inclusion of the floor on the NMRF capital requirement, when the judgement-based approach is applied, would be overly prudent. They requested the PRA remove the floor and instead allow firms to apply judgement to assess the maximum loss without any constraint.

3.50 Having considered the response, the PRA has decided to retain the approach to calculate NMRF capital requirements as consulted. The PRA considers the inclusion of the floor on the stressed loss is important – the fall-back approach requires firms to identify the maximum possible loss. Permitting an approach that calculates a loss that is not as high as an historically-observed loss could underestimate risk and therefore the required amount of capital.

Recognition of NMRFs in back-testing

3.51 Aligned with the Basel 3.1 standards, the PRA proposed to apply a multiplier to the capital requirement from the ES model where back-testing at overall portfolio level showed that, based on losses in the portfolio being modelled, it underestimated risk. The methodology would count the number of times losses were greater than the model estimate; the multiplier would increase with the number of these 'exceptions'.

3.52 The PRA also proposed to implement back-testing requirements at trading desk level. At that level, no multiplier would be applied for excessive exceptions, but if the number of exceptions exceeded a defined threshold, then firms would have to use the ASA when calculating market risk capital requirements for that trading desk.

3.53 The proposal contemplated supervisors permitting firms to disregard back-testing exceptions where the back-testing failure was not due to poor model performance, but due to risks that were not in the model but capitalised elsewhere (ie NMRFs).

3.54 The PRA proposed to adjust the Basel 3.1 standards to require firms to include NMRFs in their model, for the purpose of performing back-testing at the trading desk level. This would provide a less burdensome way to demonstrate that the model was appropriately conservative compared to requesting separate permissions for each exception on a potentially large number of trading desks to be disregarded (as required under the Basel 3.1 standards' approach). However, to ensure a firm's approach remains prudent and aligns with

Basel 3.1 standards, firms would be required to exclude NMRFs from back-testing at the overall portfolio level for the purpose of calculating any capital multiplier. At the portfolio level, aligned with Basel 3.1 standards, they would be permitted to disregard exceptions that are caused by NMRFs if approved by the PRA.

3.55 Four respondents supported the PRA's proposals for trading desk level back-testing, but requested that the PRA provide additional flexibility to allow firms to include NMRFs in the ES model when performing back-testing at the overall trading book portfolio level.

3.56 Having considered the responses, the PRA has decided to retain the approach to require NMRFs to be included in the ES model for back-testing only at trading desk level. The PRA considers this approach is proportionate and provides flexibility for recognising NMRFs in back-testing. Retaining the requirements at the portfolio level provides an important safeguard against NMRFs being modelled inaccurately due to their limited data, ensures the capital multiplier that results is appropriately conservative, and allows the PRA to be alerted to situations where NMRFs are the cause of exceptions.

Replacing the PRA's risks not in value-at-risk framework with a risks not in model framework

3.57 The PRA currently implements a risks not in value-at-risk (RNIV) framework. It requires firms with IMA permission to identify any risks which are not adequately incorporated in their model and to maintain additional capital against those risks. The RNIV framework reflects the fact that no model can capture all risks, and therefore the PRA considers that it remains relevant under the new IMA. As part of implementing the Basel 3.1 standards, the PRA therefore proposed to retain a similar framework – the RNIM framework – to set Pillar 1 capital requirements for risks not included in a firm's ES model or NMRF framework and risks not included or adequately capitalised under a firm's IMA-DRC model.

3.58 One respondent argued that risk factors covered by the RNIM framework should instead be captured through Pillar 2, noting that they expected most risk factors currently under RNIV would be part of the new NMRF framework and as such capital requirements under the RNIM framework would be lower than under the existing RNIV framework. One respondent requested clarification of the treatment of risks captured under the RNIM framework in back-testing.

3.59 Having considered the responses, the PRA has decided to retain its proposal to treat capital requirements under the RNIM framework as Pillar 1 requirements, as consulted. Due to the dynamic nature of trading book positions and the fact that Pillar 2 capital requirements are set on a less frequent basis than Pillar 1, the PRA considers it more risk-sensitive to apply RNIM capital requirements under the Pillar 1 framework.

3.60 On the approach to back-testing risks under the RNIM framework, the PRA has clarified that the existing approach to disregarding back-testing exceptions driven by RNIVs will continue to be applied. Under this approach, the PRA recognises that capital is already maintained against the risks, and firms can seek permission to disregard relevant exceptions. Given this approach to disregard exceptions, the PRA has also clarified that firms are not permitted to include RNIMs in their ES model when performing back-testing at trading desk level.

Trading desk structure requirements for IMA permissions

3.61 The PRA proposed requirements on firms' trading desk structures when applying for permission to use the IMA. One respondent asked the PRA to clarify how they should treat trading desks that contain IMA-ineligible positions (ie securitisation positions or CIU positions) when applying for IMA permission.

3.62 Having considered the responses, the PRA has decided to amend the draft rules to allow trading desks that manage IMA-ineligible positions to be included in firms' IMA application. However, firms can only use the IMA for IMA-eligible positions and would have to treat any IMA-ineligible positions under the ASA. The PRA considers its approach, which allows the management of IMA ineligible positions by an IMA desk, provides more flexibility in managing risk, while remaining prudent by ensuring the risks are appropriately capitalised under the ASA. The resulting capital requirements from this amended approach remain as proposed.

PRA objectives analysis

3.63 With the exception of the change to the treatment of sovereign exposures in the IMA-DRC, the PRC considers that the near-final IMA rules, incorporating the amendments and clarifications described above, remain materially aligned with the proposals in CP16/22 and therefore the PRA considers its analysis of its objectives and have regards for those areas in CP16/22 remains appropriate.

3.64 With respect to the PRA's decision to remove the possibility for firms to apply the IMA-DRC to sovereign exposures that are not permitted to be modelled under the IRB approach in the credit risk framework, the PRA considers the proposed approach advances the PRA's primary objective by ensuring risks are only modelled where there are sufficient data to do so in a prudent manner. The change would result in all firms applying the same treatment for the affected sovereign exposures, which would support the PRA's secondary competition objective by ensuring a level playing field across firms.

'Have regards' analysis

3.65 In developing these near-final rules, the PRA has had regard, among other things, to the Financial Services and Markets Act (FSMA) regulatory principles, the aspects of the

Government's economic policy set out in the HM Treasury (HMT) recommendation letter dated 8 December 2022 and the matters to which it is required to have regard when proposing changes to CRR rules. The PRA considers its analysis of its 'have regards', as presented in CP16/22, remains appropriate, subject to the following updates:

1. Relative standing of the UK as a place for internationally active firms to operate (FSMA CRR rules) and competitiveness (HMT recommendation letter):

- The PRA considers that the additional flexibility and clarifications as provided in the near-final rules for IMA are materially aligned with other major jurisdictions. With respect to the treatment of sovereign exposures, the change to the draft rule should result in capital requirements that are more closely aligned with those of other major jurisdictions, supporting the relative standing of the UK as a place to operate.

2. Relevant international standards (FSMA CRR rules):

- The PRA considers that the additional flexibility and clarifications as provided in the near-final rules for IMA are materially aligned with international standards. For example, amendments to permit a more flexible approach to deriving multiple risk factors from one observable price are aligned with international standards, as is the additional flexibility to test the 75% coverage of risk factors used to calibrate the ES model at overall portfolio level only. The PRA considers the change to the treatment of sovereign exposures to require them to be treated under the ASA remains aligned with international standards, which require that firms use non-modelled approaches such as the ASA unless they have permission to use a more advanced approach.

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

- The PRA considers the additional flexibility included in a number of the amendments in the near-final rules for IMA would reduce the operational burden of the IMA approach. For example, changes to requirements around the bucketing of risk factors for the purpose of the NMRF framework, and additional flexibility to test the 75% coverage of risk factors used to calibrate the ES model at overall portfolio level only, would allow firms to apply less burdensome approaches that achieve similar outcomes.

4: Credit valuation adjustment and counterparty credit risk

Introduction

4.1 This chapter provides feedback to responses to Chapter 7 of consultation paper (CP) 16/22 – **Implementation of Basel 3.1 standards**, which set out proposals to implement the Basel 3.1 standards for methodologies for credit valuation adjustment (CVA) risk. CP16/22 also proposed to amend the scope and calibration of the CVA risk and standardised approach to counterparty credit risk (SA-CCR) frameworks. This chapter also sets out the Prudential Regulation Authority's (PRA) near-final policy on CVA and SA-CCR following the consultation.

4.2 In CP16/22, the PRA proposed to implement the Basel 3.1 CVA risk framework methodologies for calculating capital requirements, comprising three new approaches: the alternative approach (AA-CVA), the basic approach (BA-CVA), and the standardised approach (SA-CVA). The new methodologies would replace the existing methodologies and improve the risk-sensitivity and comparability of CVA capital requirements. They included the following improvements to the existing approaches:

- 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 in the case of SA-CVA.

4.3 Separately, having conducted a holistic review of the CVA and counterparty credit risk (CCR) capital frameworks, the PRA also proposed changes to the scope of the CVA framework and the calibration of elements of the CVA and SA-CCR frameworks. These were designed to ensure that capital requirements would be appropriate for the relevant risks, and in doing so would materially align the CVA framework with international standards. The proposals:

- removed the existing exemptions from CVA capital requirements for transactions with sovereigns and non-financial counterparties (NFCs);
- removed the existing temporary CVA exemption for transactions with pension funds, but introduced a new risk weight that is lower than Basel 3.1 standards;
- retained the existing CVA exemption for client clearing transactions;
- retained the existing CVA exemption for intragroup transactions with an additional, more flexible, way for firms to apply it; and

- reduced the SA-CCR 'alpha factor' from 1.4 to 1 for transactions with pension funds and non-financial counterparties (NFCs), reflecting the over-calibration of SA-CCR and reducing the resulting CCR risk-weighted assets (RWAs) by approximately 30%.

4.4 The PRA received 19 responses to its proposals on CVA and SA-CCR. The respondents were broadly supportive of the key elements and the resulting alignment with international standards. Comments focused on: (i) the impact of the proposed removal of CVA exemptions and related calibration adjustments for SA-CCR; (ii) the proposed transitional approach for trades currently exempt from CVA requirements; and (iii) the calibration of CVA requirements for exposures to financial counterparties.

4.5 Having considered the responses, the PRA has decided to amend the draft rules in certain areas. This chapter describes the comments and amendments that the PRA considers are more material. As described in Chapter 1 – Overview, the PRA has also made a number of less material amendments and clarifications to the draft rules, which are not described in this chapter. These amendments are reflected in the Near-final PRA Rulebook: CRR Firms: (CRR) Instrument 2024 in Appendix 2.[20] Please refer to the document titled **Comparison of Draft PRA Rulebook (CRR) Instrument [2023] against Near-final PRA Rulebook: CRR Firms (CRR) Instrument [2024]**,[21] which contains a comparison of the near-final rules with the draft rules as set out in CP16/22 for ease of identifying all of the changes made.

4.6 The appendices to this near-final policy statement contain the PRA's near-final policy, which will:

- delete the Credit Valuation Adjustment Risk (CRR) Part of the PRA Rulebook (Appendix 2);
- introduce a new Credit Valuation Adjustment Risk Part of the PRA Rulebook, to replace the CRR requirements (Appendix 2);
- amend the Counterparty Credit Risk (CRR) Part of the PRA Rulebook (Appendix 2); and
- amend supervisory statement (SS) 12/13 – Counterparty credit risk (Appendix 5).

4.7 To provide greater clarity and transparency on the approvals process, the PRA has also updated the **Permissions (CRR firms)** webpage with documents setting out the format and content of the supporting information expected for Permissions applications relating to SA-CVA.

[20] CRR or Capital Requirements Regulation – 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.
[21] This comparison is provided due to the exceptional nature of the Basel 3.1 package, comprising multiple changes to PRA rules, and to respond to industry feedback.

4.8 The sections below have been structured broadly along the same lines as Chapter 7 of CP16/22, covering the main areas where the PRA received comments from respondents as follows:

- scope of application;
- the alternative approach;
- the basic approach;
- the standardised approach; and
- calibration of capital requirements for derivative exposures (CCR and CVA risk).

Scope of application

Credit valuation adjustment exemptions

4.9 The PRA proposed that CVA capital requirements would be calculated by all firms undertaking covered transactions in both the non-trading book and trading book. Covered transactions included:

- over-the-counter (OTC) derivatives that are not cleared with a qualifying central counterparty, or that are not client clearing transactions; 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 supervisory statement (SS) 12/13 – **Counterparty credit risk**.

4.10 Following a holistic review of capital requirements for derivatives under the CVA and CCR capital frameworks, the PRA proposed to remove existing exemptions from CVA capital requirements for transactions with sovereigns, non-financial corporates, and pension funds. The PRA proposed to retain the CVA exemption for transactions associated with client clearing. The PRA also proposed to introduce a new, firm-specific approach to exempt intragroup exposures from CVA capital requirements, subject to firms meeting certain risk management requirements.

4.11 The PRA received seven responses on the proposal to include transactions with currently exempted counterparties within the scope of CVA risk capital requirements. Respondents generally did not dispute that the CVA risk from such transactions is non-zero, but raised a number of concerns related to the impact of the proposal:

- impact on end-users of derivatives: six respondents noted that the increase in capital requirements could impact the pricing of derivatives for end-users, and potentially reduce access to the derivatives market;
- impact on competitiveness: four respondents highlighted the expected retention of exemptions in the EU could affect the competitiveness of UK firms; and

- impact on capital requirements: five respondents raised general concerns about the material increase in RWAs as a result of the inclusion of currently exempted counterparties.

4.12 The PRA also received responses on the definition of pension scheme arrangements (PSAs) and the scope of group entities potentially eligible for the intragroup exemption. Three respondents requested that the definition of a PSA be expanded to include third-country PSAs. Three respondents requested that the definition of intragroup transactions be updated to include transactions with entities located in non-UK jurisdictions within the group consolidation. One respondent recommended the risk management conditions connected to the new, firm-specific approach to exempt intragroup transactions be replaced by an equivalence determination under CRR, meaning that transactions with a group counterparty in an equivalent jurisdiction would automatically be exempt from the CVA capital requirements.

4.13 With regard to the impact of removing the CVA exemptions, having considered the responses, the PRA has decided to maintain the package of changes proposed in CP16/22. The PRA considers that the transactions for which the exemptions would be removed could have material CVA risk that should be capitalised. There was little evidence provided by respondents that the risk of transactions with the relevant counterparties was immaterial. Although several firms argued there would be potential impacts on pricing, access to derivatives, or competitiveness, the PRA did not receive persuasive evidence, either from domestic or international experience, that supported these assertions.

4.14 As set out in CP16/22, the PRA's analysis, including through a pricing survey conducted in 2021, indicated that increases or decreases in CVA capital requirements are not automatically passed on to counterparties through prices. To the extent any cost is passed on, it is not clear that these costs are material or disproportionate to the risk. The PRA also notes that the package of changes includes adjustments to the calibration of SA-CCR that reduce the impact on overall capital held against counterparty credit risk of removing exemptions. The PRA does acknowledge however that there will be an increase in CVA capital requirements. To provide firms time to adjust, the PRA proposed a transitional arrangement and has taken account of responses on how that can be made as operationally simple as possible (discussed in the next section).

4.15 With regard to the definition of PSAs, the PRA agrees with respondents that the risk of transactions of PSAs is unlikely to materially differ across jurisdictions, and therefore has decided to amend the definition to include both UK PSAs and all third-country funds that would be PSAs if they were located in the UK.[22]

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[22] The third-country PSA reference in this definition will not apply to the transitional arrangements, which only includes previously exempted pension fund counterparties (see sub-section 'transitional arrangements for legacy trades').

4.16 Having considered the responses received, the PRA has amended the definition of intragroup transactions to include transactions between certain overseas group entities. However, the PRA was not persuaded that basing exemptions on a link to the current CRR equivalence regime would appropriately capture transaction-specific risks and has decided to retain the intragroup risk management conditions as proposed given they are tailored to capture firm-specific CVA risks. The PRA notes that HM Treasury (HMT) intend to also retain the existing CRR intragroup exemption treatment for cross-border groups, including for counterparts in jurisdictions where a European Market Infrastructure Regulation (EMIR) equivalence determination has been made.

Transitional arrangements for legacy trades

4.17 The PRA proposed a transitional arrangement for CVA and SA-CCR capital requirements for trades with counterparties that would be exempt from CVA requirements immediately before the implementation of the Basel 3.1 standards (so-called legacy trades). CVA-exempted trades would continue to be optionally exempt until 1 January 2030. As part of the broader package of CVA and SA-CCR recalibrations, the PRA had proposed to adjust the SA-CCR alpha multiplier for transactions with NFCs and pension funds, permitting them to adopt an alpha multiplier equal to 1, including on legacy trades. To avoid legacy transactions having inappropriately low capital requirements through the lower alpha factor in SA-CCR and the transitional legacy CVA exemption treatment, the PRA proposed that firms applying the CVA transitional would be required to maintain additional Pillar 1 capital equal to the day 1 capital benefit of the SA-CCR alpha multiplier reduction on legacy trades, reduced linearly over the transitional period (known as the alpha 'add-on').

4.18 All respondents were supportive of a transitional regime for legacy transactions, and a number of respondents supported the CVA transitional as proposed. However, six respondents highlighted potential operational challenges of separating legacy and non-legacy trades, noting that excluding some from the CVA framework would perpetuate a misalignment between accounting and regulatory CVA risk calculations. One respondent also noted concerns about the potential for a 'cliff edge' at the end of the transitional period. Respondents proposed an alternative transitional approach under which firms could include legacy trades in the CVA calculation, but apply a discount factor to scale down the resulting capital requirement to reflect the CVA risk from legacy trades.[23] Respondents argued this would avoid significant operational burden associated with the segregation of new and legacy transactions. Firms proposed they would not apply the SA-CCR alpha add-on under this approach. Four respondents asked for clarification on whether the alpha add-on should be applied to other parts of the capital framework where SA-CCR is used.

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[23] The discount scalar would be the proportion of CVA capital requirements from exempted trades relative to total (as calculated by BA-CVA), as at implementation date. This scalar would be reduced linearly over the transitional period.

4.19 Given the PRA received a number of supportive responses to the transitional arrangement proposed in CP16/22, it has decided to retain this approach as an option. Nevertheless, the PRA accepts that for some firms there are potential operational challenges with the transitional proposal in CP16/22 and has decided to add an alternative optional transitional approach broadly aligned with that proposed by respondents. Firms will be required to select one transitional approach only and apply it consistently over the transitional period to 1 January 2030. However, the PRA is retaining the alpha add-on for both the originally proposed and alternative transitional to ensure firms maintain adequate capital across CCR and CVA risk during the transitional period. The PRA has updated SS12/13 to clarify its expectations related to each transitional approach. It has also clarified in the rules that the SA-CCR transitional add-on will not apply within the leverage ratio framework, but no changes have been made in other cases where SA-CCR is used in the capital framework.

Interaction between the scope of the CVA framework and the maturity factor in CCR calculations

4.20 The BA-CVA and SA-CVA approaches take into account the exposure and maturity of derivative transactions with counterparties. The PRA proposed that where a netting set is subject to such CVA capital requirements, it may cap the maturity adjustment factor to 1 in the internal ratings based (IRB) approach risk weight formula for CCR.

4.21 Two respondents requested clarification on how to treat netting sets for CCR purposes when they contain some CVA exempt transactions. Specifically, whether firms can cap the maturity adjustment factor for CCR purposes at 1 for the netting set in these cases, and whether it is possible to retain a single netting set for CCR purposes.

4.22 The PRA can clarify that firms cannot cap the maturity adjustment factor at 1 for CCR netting sets where they include trades that are exempt from CVA capital requirements. The capping of the maturity adjustment factor is to account for the potential double-count in downgrade risk in the CVA and credit risk frameworks. If transactions are excluded from the CVA framework, then there is no potential for double-counting. The PRA can also clarify that rules related to netting sets for CCR purposes have not been amended. Therefore, legal netting sets should not be split for CCR purposes in response to adjustments to CVA netting sets.

PRA objectives analysis

4.23 The PRA considers that broadening of the definition of PSAs and the scope of intragroup exemptions – in both cases where the expanded range of transactions in scope have the same broad risk characteristics as those in the original proposals – would not affect the assessment in CP16/22 that the CVA risk framework would advance the PRA’s primary objective. The amendments would apply consistently across the BA-CVA and SA-CVA approaches and therefore would not impact effective competition between firms.

4.24 The additional transitional arrangement for legacy trades would result in broadly similar capital requirements to the original proposal during the transitional period, and since both transitional options are available for firms to choose, no firm can be worse off than under the proposals in CP16/22. Therefore, there is no change to the assessment in CP16/22 of how the transitional would advance the PRA's primary and secondary objectives.

4.25 For all other aspects of the scope of application of the CVA framework, the PRA considers its analysis of its objectives, as presented in CP16/22, remains appropriate.

'Have regards' analysis

4.26 In developing these near-final rules, the PRA has had regard, among other things, to the Financial Services and Markets Act (FSMA 2000) regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter dated 8 December 2022 and the matters to which it is required to have regard when proposing changes to CRR rules. The PRA considers its analysis of its 'have regards', as presented in CP16/22, remains appropriate, subject to the following updates:

1. Relative standing of the UK as a place for internationally active firms to operate (FSMA CRR rules) and competitiveness (HMT recommendation letter):

- The PRA considers its amendments to include third-country PSAs in the pension scheme arrangement definition and non-UK intragroup entities in the scope of CVA exemptions, will support the relative standing of the UK as a place to operate by more closely aligning the UK approach with that in other major jurisdictions.

2. Relevant international standards (FSMA CRR rules):

- The PRA considers that the amendments are materially aligned with international standards, and therefore the CVA and CCR near-final rules also remain materially aligned.

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

- The PRA considers the introduction of an additional transitional arrangement would ensure the burden imposed on firms is aligned to its benefits, reduce operational burden of the transitional approach, and provide sufficient time for firms to adjust to any impact from the removal of exemptions from CVA capital requirements.

The alternative approach

4.27 The PRA proposed to introduce an alternative approach (AA-CVA) for firms with limited non-centrally cleared OTC derivatives. Firms with a notional amount of non-cleared derivatives less than or equal to £88 billion would (subject to pre-notifying the PRA) be permitted to use the AA-CVA. The AA-CVA approach would set CVA risk capital requirements equal to 100% of the CCR capital requirements.

4.28 Respondents generally supported the proposed alternative approach. One respondent suggested that the AA-CVA notional threshold should be based only on the notional amount of non-centrally cleared derivatives that are in scope of CVA risk requirements. One respondent requested clarification as to whether SFT exposures that are calculated under the credit risk mitigation (CRM) framework rather than the CCR framework should be included in AA-CVA calculations.[24]

4.29 Having considered these responses, the PRA has decided to retain the existing threshold calculation as proposed. The AA-CVA approach is for firms with limited OTC activities, meaning limited derivatives or SFT exposures of any type. It is important that the threshold calculation is proportionate and simple for firms and their supervisors to calculate and monitor. This approach aligns with international standards and other major jurisdictions. The PRA acknowledges that the proposed rules were unclear on the treatment of SFTs. The rules have been amended to clarify that the AA-CVA calculations should also include capital requirements for SFTs when the exposure value is calculated using the CRM framework. This clarification aligns with the simple, conservative methodology intended for smaller firms, while appropriately capturing the risk.

PRA objectives and 'have regards' analysis

4.30 The near-final rules, including the clarification on the treatment of SFTs, are consistent with the proposals in CP16/22 and therefore the PRA considers its analysis of its objectives and 'have regards' in CP16/22 remains appropriate.

The basic approach

4.31 The PRA proposed to introduce a basic approach for CVA (BA-CVA), to be applied by firms that do not use the AA-CVA or do not have permission to use the advanced standardised approach (SA-CVA). Under this approach, firms could calculate CVA capital requirements using either the:

- 'reduced' BA-CVA, a simplified methodology for firms that do not hedge CVA risk; or
- 'full' BA-CVA, intended for firms that hedge the counterparty credit spread component of CVA risk.

4.32 The BA-CVA approach calculates CVA capital requirements per counterparty on a stand-alone basis, using a methodology which:

[24] Firms have the option to include SFT exposures under the CRM framework or CCR framework.

- maps the counterparty to its relevant risk category to determine the risk weight;
- takes into account the exposure and maturity of the transactions; and
- aggregates the counterparty-level CVA capital requirements using a formula that recognises a specified fixed correlation between different counterparties.

4.33 Responses generally focused on how maturity of transactions is taken into account in the calculation. The proposed rules floored the maturity of netting sets at 1 year if a firm does not have permission to use the internal model method (IMM) for counterparty credit risk. One respondent noted that the proposed rules appeared to be more conservative than the Basel 3.1 standards, which permit a shorter maturity in certain cases (eg short-term exposures that are fully collateralised). One respondent argued that the one-year floor should not apply in any situation – there should be a 10 business day floor irrespective of the collateralisation of the exposure.

4.34 After considering these responses, the PRA has amended the near-final rules to clarify that the maturity floor does not apply to collateralised transactions, to align with international standards. The PRA acknowledges that the proposals were not clear on the treatment of these types of exposures. However, the PRA considers that there was insufficient evidence in responses to justify a lowering or removal of the maturity floor for uncollateralised exposures. These types of exposures have more risk, all else equal, than collateralised exposures, so the PRA considers it would be inconsistent with the PRA's primary objective to permit the same lower capital requirement. It would also deviate from the maturity definition in the credit risk framework, creating inconsistencies across PRA rules.

PRA objectives and 'have regards' analysis

4.35 The near-final rules align with the intent of those in CP16/22 and therefore the PRA considers its analysis of its objectives and 'have regards' in CP16/22 remains appropriate.

The standardised approach

4.36 The PRA proposed to introduce a standardised approach for CVA (SA-CVA). Firms would require permission from their supervisors to use this approach. 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 probability of default and expected loss given default, where spread data is not directly available (known as ‘proxy credit spreads’).

Treatment of financial counterparties

4.37 The SA-CVA methodology assigns exposures to sector buckets, aligned with broad industry classifications. Firms then apply different specified risk weights by sector and counterparty credit quality. The PRA proposed to aggregate risk positions into eight risk categories based on the sector of the counterparty. Financial counterparties would be allocated to one of two risk categories: one for financial and quasi-financial entities, and one for pension funds. The introduction of a pension fund category was a deviation from international standards introduced in the PRA’s proposals to reflect the lower counterparty credit spread risk of transactions with pension funds. A similar adjusted approach for pension funds was included in the BA-CVA.

4.38 Seven respondents supported the introduction of the new pension fund category, but argued that the proposed risk categories for financial entities were still not granular enough to adequately distinguish between types of financial institutions. They requested the PRA expand the scope of the new pension fund risk category to include any prudentially regulated entities and regulated funds (including undertakings for the collective investment in transferable securities, UCITS).

4.39 The PRA has considered the responses, and decided its proposals struck the appropriate balance between simplicity (by limiting the number of different categories for exposures to be allocated to, given this is a standardised approach) and ensuring material CVA risks with financial counterparties are not undercapitalised. The PRA considered the risk profile of regulated firms and UCITS relative to other financial institutions, but the evidence available did not provide a sufficient basis for aligning them with the pension fund risk category. The PRA also notes that assigning a broader range of financial counterparties to another bucket with a lower risk weight would also require an upward recalibration of the existing financial entity bucket, likely offsetting a portion of any overall reduction in capital requirements. It would also cause the PRA approach to substantially deviate from the international standard and the approach of most other jurisdictions.

Other technical issues

4.40 Other substantive responses focused on a range of technical issues:

- **Margin period of risk:** Two respondents recommended that the floor on one of the inputs to the SA-CVA calculation – the margin period of risk (MPoR) – be reduced or removed. The margin period of risk is the period over which a position is assumed to be closed out in the event of a default of a counterparty, and is an important assumption in the CVA calculation. The PRA considered the responses, but did not find persuasive evidence to support the conclusion that positions can be reliably and consistently closed out within a shorter period than the floor. A shorter MPoR could therefore result in an underestimation of appropriate capital requirements.

- **Scope of eligible hedges:** To provide consistency with the market risk approach, and in line with international standards, the proposals limited the scope of eligible hedges to those eligible in the market risk internal model approach (IMA). One respondent suggested an expansion of the scope of eligible SA-CVA hedges to include ineligible hedges under the market risk IMA. The PRA considers that hedges that cannot be included in the IMA are likely to be complex and therefore not able to be appropriately taken into account in the less sophisticated SA-CVA. It has therefore not expanded the scope to ineligible IMA hedges.
- **Recognition of diversification across buckets:** Four respondents asked for greater flexibility in mapping trades to sector buckets, in part to more closely align with accounting CVA calculations. Five respondents suggested that cross-bucket correlations needed to be increased, especially for index credit default swaps (CDS) hedges, to better reflect the risk-reducing impact of these hedges. The PRA views that permitting more flexible mapping could result in the overestimation of offsetting benefits, and would therefore be inconsistent with its primary objective. The PRA is not persuaded that there is evidence to support greater recognition of index CDS hedges through a higher correlation factor.
- **Treatment of netting sets without complete SA-CVA permission:** Two respondents requested the rules clarify whether firms may split legal netting sets into ‘synthetic’ netting sets where SA-CVA permission has not been granted for all positions in the legal netting set. They argued allowing this approach would enhance flexibility in applying CVA methodologies. The PRA has agreed to clarify that firms may split a legal netting set where the firm does not have SA-CVA permission for all positions in that netting set. This approach will continue to align capital with risk, ease operational burden, and aligns with the Basel 3.1 standards.
- **Expectations related to SA-CVA:** A number of respondents requested additional detail on the PRA’s expectations on a range of technical aspects of SA-CVA. The PRA has provided further detail in SS12/13 of its expectations on: (i) the calculation of regulatory CVA; (ii) the use of alternative methodologies for delta and vega sensitivities; (iii) the treatment of onshore and offshore currencies; and (iv) the use of market data from firms’ CVA desks in exposure models. The PRA considers that the clarifications will support consistent implementation of the methodology.

PRA objectives and ‘have regards’ analysis

4.41 The near-final rules, incorporating the clarifications above, align with those in CP16/22 and therefore the PRA considers its analysis of its objectives and ‘have regards’ in CP16/22 remains appropriate.

Calibration of capital requirements for derivative exposures (CCR and CVA risk)

4.42 In CP16/22, the PRA set out its considerations related to the aggregate capital requirements for derivatives from SA-CCR and the Basel 3.1 standards' CVA risk framework. It noted areas where data suggested the calibration was overly conservative and proposed to address that by:

- reducing the SA-CCR alpha factor from 1.4 to 1 for exposures to pension funds and NFCs; and
- introducing a separate risk category and risk weight for pension funds in the CVA framework. The new risk weight would represent an approximately 30% reduction compared to the Basel 3.1 standards.

4.43 Respondents supported the PRA's proposed treatment of pension funds in the CVA framework. Responses focused on arguments for additional reductions in the calibration of the SA-CCR framework. In particular, five respondents suggested that the SA-CCR alpha factor should be reduced to 1 for all counterparties.

4.44 The PRA has considered the responses and decided to retain the proposed alpha factor reduction for NFCs and pension funds only. As stated in CP16/22, the PRA's proposals were informed by a data collection exercise that identified specific groups of transactions where a deviation from international standards was appropriate due to SA-CCR being over-calibrated relative to the IMM. Respondents did not provide persuasive evidence that other types of transactions had a similar over-calibration.

PRA objectives and 'have regards' analysis

4.45 The near-final rules are consistent with those in CP16/22 and therefore the PRA considers its analysis of its objectives and 'have regards' in CP16/22 remains appropriate.

5: Operational risk

Introduction

5.1 This chapter provides feedback to responses to Chapter 8 of consultation paper (CP) 16/22 – **Implementation of the Basel 3.1 standards**, which set out proposals to implement the Basel 3.1 standards for operational risk. This chapter also sets out the PRA's near-final policy on operational risk following the consultation.

5.2 In CP16/22, the PRA proposed to implement a new standardised approach (SA) for Pillar 1 operational risk capital requirements and exercise the national discretion included in the Basel 3.1 standards to set the internal loss multiplier (ILM) equal to 1. The new SA would replace all existing approaches for Pillar 1 operational risk requirements.

5.3 The PRA received 25 responses to its proposals on operational risk. The respondents were broadly supportive of the key elements of the proposals. Comments focused mainly on the details of the calculation of the SA.

5.4 Having considered the consultation responses, the PRA has decided to amend the draft rules in certain limited areas including, as described below, to allow firms to:

- Exclude divested activities from the calculation of the business indicator (BI) where entities or activities have been disposed and using a three-year average to calculate the BI would lead to a biased estimation of the operational risk capital requirements. This would be subject to supervisory approval and is in line with the intention of CP16/22.
- Calculate the BI and sub-components using business estimates when audited figures are not available.

5.5 This chapter describes the comments and amendments that are, in the PRA's opinion, more material. As described in Chapter 1 – Overview, the PRA has also made a small number of less substantive changes to the draft rules to promote greater clarity and consistency, which are not described in this chapter. These amendments are reflected in the near-final PRA Rulebook: CRR Firms: (CRR) Instrument 2024 in Appendix 2.[25] Please refer to the document titled **Comparison of Draft PRA Rulebook (CRR) Instrument [2023] against Near-final PRA Rulebook: CRR Firms (CRR) Instrument [2024]**,[26] which contains

[25] In this near-final PS, CRR refers to 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.
[26] This comparison is provided due to the exceptional nature of the Basel 3.1 package, comprising multiple changes to PRA rules, and to respond to industry feedback.

a comparison of the near-final rules with the draft rules as set out in CP16/22 for ease of identifying all of the changes made.

5.6 The appendices to this near-final policy statement (PS) contain the PRA's near-final rules, which will:

- introduce the new requirements for operational risk in a new Operational Risk Part of the PRA Rulebook (Appendix 2);
- make consequential changes to the Benchmarking of Internal Approaches Part (Appendix 2); and
- revoke the Operational Risk (CRR) Part of the PRA Rulebook (Appendix 2).

5.7 The sections below have been structured broadly along the same lines as Chapter 8 of CP16/22, covering the main areas where the PRA received comments from respondents as follows:

- implementation of the standardised approach in PRA rules
- exercising the national discretion to set the ILM equal to 1

Implementation of the standardised approach in PRA rules

5.8 The PRA proposed to replace all existing approaches for calculating Pillar 1 operational risk capital requirements with the SA in the Basel 3.1 standards.

5.9 Nine respondents expressed broad support for this proposal. However, there were a number of responses that provided comments on the appropriateness of specific elements within the SA methodology.

- Two respondents requested that the SA recognise hedging or insurance against future losses.
- One respondent requested that dividends used to repatriate capital should be excluded from the BI.
- One respondent questioned why the services component of the BI does not include offsets or a cap, arguing that higher services revenues would inappropriately result in higher capital requirements.

5.10 A number of responses also provided broader comments about the SA methodology.

- Three respondents argued that, while they agreed that generally larger organisations are more exposed to operational risk and the SA should recognise this, that assumption may not apply to 'large and simple' organisations like building societies.
- One respondent noted that under the SA, operational risk capital requirements at a consolidated level are likely to be greater than the sum across subsidiaries.

- One respondent argued that their operational losses have never reached the extent of capital held and that existing and proposed rules penalise firms that are operationally simple.

5.11 Finally, one respondent raised concerns about having two different allocation methodologies for internal losses under Pillar 1 and Pillar 2.

5.12 Having considered the responses, the PRA has decided to maintain implementation of the SA as proposed. With regard to the comments on specific elements of the SA methodology, the PRA considers that:

- The risks of recognising operational risk insurance as a direct capital mitigant outweigh any benefits. This is particularly in view of the added complexity and prudential risks associated with operational risk insurance, including the reliability and timeliness of payouts.
- It is important that dividend income is included in the BI, as it is a key component of a firm's financial statement.
- Introducing a cap or offsets to the services component would result in an underestimation of the scale of a firm's operations, which is a key indicator of the level of operational risk.

5.13 With regard to the broader comments received on the SA, the PRA considers that:

- The size and complexity of firms is a relevant factor in considering operational risk as part of the BI and business indicator component (BIC) and the SA enhances risk-sensitivity relative to the existing CRR Pillar 1 operational risk framework. This is supported by evidence that the size of a firm is the dominant differentiator of operational risk.[27]
- Operational risk capital requirements being greater at the consolidated level than the sum across subsidiaries is an intended outcome of the BIC varying based on the size of the firm. This is supported by evidence that operational risk loss exposure increases more than proportionately with the BI.[28] As such, higher capital requirements at the consolidated level are appropriate.
- The infrequent but potentially large magnitude of operational risk losses means past events are generally not good predictors of future losses.

5.14 With regard to the differences between Pillar 1 and Pillar 2, the PRA is aligning Pillar 1 operational risk loss data collection requirements with the Basel 3.1 standards and will be reviewing its Pillar 2A methodology and any associated reporting as part of the broader future Pillar 2A methodology review (see Chapter 6 – Pillar 2 for further detail).

[27] BCBS – **Operational risk – Revisions to the simpler approaches**.
[28] BCBS – **Standardised Measurement Approach for operational risk**.

5.15 In addition to the responses above on the SA methodology, a number of respondents requested clarifications related to the intent of the draft rules. Four respondents stated that the draft rules did not appear to reflect the intention set out in CP16/22 that firms can apply to the PRA for permission to exclude divested activities from the calculation of the BI where a firm can prove that their inclusion leads to a biased estimate. One respondent noted that the draft rules did not permit the use of business estimates in the calculation of the BI, which could pose an issue for firms as audited figures may not always be available.

5.16 Having considered these responses, the PRA has amended the rules such that firms can:

- in line with the intention of CP16/22, request supervisory approval to exclude divested activities from the calculation of the BI when 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; and
- calculate the BI and sub-components with business estimates when audited figures are not available – the PRA considers this will ease the burden of implementing the SA without any material impact on outcomes.

PRA objectives and 'have regards' analysis

5.17 The near-final policy, including the amendments described above, remains materially in line with the proposals in CP16/22 and, therefore, the PRA considers its analysis of its objectives and 'have regards' in CP16/22 remains appropriate.

Exercising the national discretion to set the ILM equal to 1

5.18 The PRA proposed to exercise the national discretion included in the Basel 3.1 standards to set the ILM equal to 1 to remove the mechanical link to historical internal operational risk losses.

5.19 Twenty respondents were supportive of the proposal, with one respondent also suggesting the PRA should consider allowing firms to adjust Pillar 2A based on a variable ILM. One respondent did not support the proposals, arguing this is a blunt approach and not in line with the risk-based approach of other capital requirements. The respondent argued that the proposal would disproportionately penalise firms that have not incurred operational losses above the market average.

5.20 Having considered the responses, the PRA has decided to maintain its proposal to set the ILM equal to 1, exercising the national discretion in the Basel 3.1 standards. The PRA acknowledges that historical losses can provide some important information when considering operational risk. However, as set out in CP16/22, the PRA considers that a mechanical link to past losses is inappropriate for a number of reasons, including that the 'fattailed' nature of operational risk losses – being infrequent but very large – means past events (particularly over a lengthy historical period) are generally not good predictors of future losses. The PRA will continue to use its more flexible Pillar 2A methodology, which applies supervisory judgement when considering the relevance of past losses to future exposure to operational risk.

PRA objectives and 'have regards' analysis

5.21 The near-final policy is as proposed in CP16/22. Therefore, the PRA considers that the objectives and 'have regards' analysis presented in CP16/22 remain appropriate for the final policy.

6: Pillar 2

Introduction

6.1 This chapter provides feedback to responses to Chapter 10 of consultation paper (CP) 16/22 – **Implementation of the Basel 3.1 standards**, which described the implications of the proposed changes to the Pillar 1 risk-weighting framework for the Prudential Regulation Authority's (PRA) Pillar 2 framework.[29]

6.2 CP16/22 did not contain any policy proposals for Pillar 2, but it set out the topics the PRA is considering so that the Pillar 2 requirements have been updated as necessary to implement the Basel 3.1 standards. In particular, it outlined the PRA's principle that it would not double count capital requirements for the same risks in both Pillar 1 and Pillar 2A.

6.3 The PRA received forty-seven responses related to Pillar 2, including requests for further clarity on the timing and details of the intended review of Pillar 2A methodologies, and details on how and when firms' Pillar 2 capital requirements would be adjusted ahead of the implementation of the Basel 3.1 standards to address double counts. The PRA also received responses related to specific elements of the Pillar 2 framework, including on individual Pillar 2A methodologies, the refined methodology to Pillar 2A[30] and buffers.

6.4 Having considered the consultation responses, this chapter sets out the PRA's plan to conduct an off-cycle review of firm-specific Pillar 2 capital requirements ahead of the implementation date of the Basel 3.1 standards on 1 July 2025 ('day 1') to address potential double counting.

6.5 The PRA acknowledges concerns raised by respondents that there could be significant timing challenges to consult and finalise new Pillar 2A methodologies, and subsequently review firm-specific Pillar 2 capital requirements ahead of day 1. Therefore, as set out in this chapter, the PRA intends to conduct a broader review of Pillar 2A methodologies after finalisation of the PRA rules to implement the Basel 3.1 standards. Any future changes to methodologies would be the subject of a separate consultation.

6.6 The PRA considers that separating the review of firm-specific Pillar 2 capital requirements from the review of Pillar 2A methodologies is the most pragmatic and least burdensome way to update the Pillar 2 framework to reflect the implementation of the Basel 3.1 standards. Any double counts as the Basel 3.1 standards are introduced and any

[29] 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**, July 2015.

[30] The methodology is set out in policy statement 22/17 – **Refining the PRA's Pillar 2A capital framework**, October 2017.

unwarranted higher (or lower) requirements can be sufficiently addressed through adjustments made within the existing methodologies.

6.7 As explained in Chapter 1 – Overview, the PRA intends to publish a second near-final PS in Q2 2024, providing feedback to responses to the chapters of CP16/22 not addressed in this near-final PS (including those related to credit risk and the output floor). The PRA's feedback to responses relevant to the Pillar 2A credit risk methodology, use of internal ratings based benchmarks, and the interaction with the output floor will be addressed in that publication.

6.8 The following sections in this chapter have been structured broadly along the same lines as Chapter 10 of CP16/22, with some areas rearranged to better respond to related issues, as follows:

- review of the Pillar 2 framework
- off-cycle review of firm-specific capital requirements
    - Pillar 2A – Operational risk
    - Pillar 2A – Market risk and credit valuation adjustment (CVA) risk
    - other Pillar 2A methodologies
    - combined buffer and PRA buffer
- other comments
    - Refined methodology to Pillar 2A
    - Interaction with the strong and simple framework
    - Pillar 2 requirements setting process

Review of the Pillar 2 framework

6.9 In CP16/22, the PRA indicated its intention to review its Pillar 2A methodologies more fully by 2024, so that Pillar 2 requirements and any corresponding reporting requirements would be updated as necessary in light of the changes from the Basel 3.1 standards to the Pillar 1 framework. The PRA also set out its principle not to double count capital requirements for the same risks in Pillar 1 and Pillar 2A.

6.10 The PRA highlighted the risk that, in the absence of any action, firms' Pillar 2 requirements would not be calibrated to their revised Pillar 1 risk-weighted assets (RWAs) on day 1. This could persist for a longer period for firms subject to a less frequent Capital Supervisory Review and Evaluation Process (C-SREP) cycle. Therefore, the PRA indicated it would consider how to avoid gaps or duplications in the Pillar 1 and Pillar 2 frameworks on day 1.

6.11 Eighteen respondents asked for more transparency on the timing and details of the Pillar 2 methodologies review for the purposes of capital planning, with some concerned that increases in Pillar 1 requirements would flow through to Pillar 2A requirements and buffers, and suggested the PRA review the Pillar 2 framework and calibration. In addition, some respondents highlighted the tight timelines between the expected publication date of final rules and the implementation date. Those respondents noted this would mean firms may have limited time for capital planning and risk management upgrades to prepare for final rule changes and any changes to Pillar 2 methodologies.

6.12 Twenty two respondents asked for further details on how firms' Pillar 2 capital requirements would be adjusted ahead of implementation to address double counts and offset increases in Pillar 1 requirements. Thirteen respondents raised concerns over some firms' less frequent C-SREP cycles and suggested the PRA adjust Pillar 2 requirements as soon as the Basel 3.1 standards are implemented.

6.13 The PRA acknowledges that firms' Pillar 2 capital requirements will need to be adjusted at the same time as the Basel 3.1 standards are implemented to address double counts and changes in RWAs. It also acknowledges the potential timing challenges if firms would need to plan for changes in Pillar 2A methodologies in addition to preparing for rule changes. Taking these responses into account, the PRA intends to sequence its Pillar 2 review work by first addressing the consequential impacts of Basel 3.1 Pillar 1 changes on Pillar 2 within the existing methodologies, and then reviewing the Pillar 2A methodologies after the PRA's rules are finalised.

6.14 The PRA considers that double counts and any unwarranted higher (or lower) requirements can be sufficiently addressed through adjustments made within the existing methodologies. Indeed, as discussed in CP16/22, Pillar 2A operational risk and market risk add-ons could be adjusted without changes to the relevant methodologies. On that basis, the PRA plans to conduct an off-cycle review of firm-specific Pillar 2 capital requirements ahead of day 1. The details of this review are explained in the next section. The purpose of this review is not to offset all changes in firms' Pillar 1 requirements, given that Pillar 2 methodologies are a bottom-up exercise to measure particular risks not captured in Pillar 1 and are not a top-down 'pool' of capital. Instead, the aim is to address risks previously captured under Pillar 2 that will be captured in Pillar 1 following the implementation of the Basel 3.1 standards and to avoid any unwarranted higher (or lower) requirements as a result of changes to RWAs.

6.15 The PRA considers that the Pillar 2A methodologies review would be more appropriate after the PRA's rules are finalised. This would also reduce the burden on firms and the PRA which would otherwise need to plan for changes in methodologies while implementing the PRA rules. Therefore, the PRA does not intend to conduct a broader review of Pillar 2A methodologies until after finalisation of the PRA rules to implement the Basel 3.1 standards.

Off-cycle review of firm-specific capital requirements

6.16 This section provides further details of the PRA's intention to conduct an off-cycle review of firm-specific Pillar 2 requirements within the PRA's existing Pillar 2 methodologies. In view of the timeline for implementation of the Basel 3.1 standards, the PRA would not expect firms to conduct a full Internal Capital Adequacy Assessment Process (ICAAP) for the purposes of this review. Therefore, the PRA does not plan to reset firms' Pillar 2 capital requirements fully through a full C-SREP process before day 1. Instead, the PRA intends to:

- adjust firms' Pillar 2 capital requirements to address double counts identified; and/or
- rebase[31] firms' variable Pillar 2A requirements and PRA buffer so that the changes to Pillar 1 RWAs do not result in unwarranted higher (or lower) Pillar 2 capital requirements where the relevant risk level has not changed.

6.17 The PRA will conduct a firm data collection exercise to inform the above adjustments, and further details will be announced in due course.

6.18 The sub-sections below describe how the PRA intends to adjust specific elements of firms' Pillar 2 requirements in this off-cycle review. Supervisory judgement will also be applied, taking into account the quality of firms' data submission and supervisory knowledge of the firms' portfolios acquired via continuous assessment. The PRA plans to communicate to firms the adjusted Pillar 2 requirements (ie the outcome of this off-cycle review) ahead of day 1, so that firm-specific requirements would be updated at the same time that the Basel 3.1 standards are implemented. The PRA will announce further details of this off-cycle review in the second near-final PS, including the approach to credit risk and details of the capital-setting process.

Pillar 2A – Operational risk

6.19 In CP16/22, the PRA stated that, all else being equal and irrespective of whether firms' Pillar 1 RWAs for operational risk change with the Basel 3.1 standards, most firms' total Pillar 1 plus Pillar 2A operational risk capital requirements would remain unchanged as a result of implementing the Basel 3.1 standards. That is because any Pillar 2A add-on would be adjusted in line with any changes in Pillar 1 RWAs.

6.20 Seven respondents expressed concerns about potential double counts and asked for more clarity on the PRA's intended approach, so that total capital requirements for operational risk stay at similar levels to those currently in place.

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[31] Rebasing means taking firms' existing nominal Pillar 2 requirement and rescaling it as a fixed percentage of projected RWAs under the Basel 3.1 standards. Given these Pillar 2 requirements are set as a percentage of total RWAs, they will continue to scale with changes in firms' RWAs arising from the implementation of the Basel 3.1 standards.

6.21 The PRA acknowledges the concerns on potential double counts and confirms that it plans to mechanically adjust firms' Pillar 2A operational risk requirements in line with any changes in Pillar 1 RWAs, so that the total nominal operational risk requirements for most firms would remain unchanged as a result of the Basel 3.1 standards being implemented.[32]

Pillar 2A – Market risk and CVA risk

6.22 In CP16/22, the PRA stated that, in line with the existing methodology set out in the **Pillar 2 statement of policy**, it would reduce Pillar 2A capital add-ons for market risk where appropriate to reflect the extent to which illiquid risks currently addressed in Pillar 2A are captured in the revised Pillar 1 framework.

6.23 Five respondents expressed concerns that extra capital would be maintained against these risks and asked for further clarity on the methodology for the above adjustment, including the interaction with changes in the CVA risk framework.

6.24 The PRA confirms that for firms with a more significant trading book, it will adjust the market risk add-ons for areas previously captured under Pillar 2A that will now be either partially or fully covered in Pillar 1 (eg illiquid and concentrated positions). Similarly, the PRA will consider how add-ons related to CVA risk would need to be adjusted to address improved capture in Pillar 1 (eg removal of some counterparty exemptions). The PRA will also rebase firms' market risk and CVA risk-related add-ons for all firms.

Other Pillar 2A methodologies

6.25 In line with the PRA's intention to adjust specific elements of firms' Pillar 2 requirements in this off-cycle review, the PRA will also rebase other variable Pillar 2A add-ons. While credit concentration risk and interest rate risk in the banking book are not addressed under Pillar 1 and the Basel 3.1 standards might not bring direct changes to the methodologies, the PRA plans to rebase these requirements so that the changes to Pillar 1 RWAs do not result in unwarranted higher (or lower) Pillar 2A requirements where the relevant risk level has not changed.

6.26 Fixed Pillar 2A add-ons (eg pension obligation risk) are unaffected by changes to Pillar 1 capital and, therefore, they will not be adjusted.

Combined buffer and PRA buffer

6.27 In CP16/22, the PRA recognised the proposed changes to Pillar 1 risk weight approaches and their cyclicality would have consequential effects for the combined buffer and the PRA buffer framework.

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[32] The adjustment will be limited to the amount of a firm's existing Pillar 2A operational risk requirements and is not applicable to firms which currently do not have Pillar 2A operational risk add-ons. For these firms, no adjustments will be made to address any increase in Pillar 1 operational risk requirements.

6.28 Ten respondents provided suggestions on how the PRA could review its buffer framework. Four respondents provided reflections on the interaction with stress testing and requested further guidance on the stress testing scenarios. While the PRA does not intend to propose any policy changes to the buffer framework at this stage, the PRA will consider whether and how it could be reviewed in future.

6.29 In the meantime, as part of the off-cycle review, the PRA plans to rebase firms' PRA buffer; ie taking firms' existing nominal PRA buffer and rescaling it as a fixed percentage of projected Basel 3.1 RWAs. This intends to ensure that the changes to RWAs do not result in an unwarranted higher (or lower) PRA buffer as a result of RWA changes that may not be related to the size of the stress impact.[33] The PRA considers that this is the most proportionate approach given that more time and analysis would be needed to understand the behaviour of the new Pillar 1 framework under a severe, but plausible, stress and the practical challenges for firms to conduct another stress test before day 1.

Other comments

Refined methodology to Pillar 2A

6.30 In CP16/22, the PRA stated its intention to consider whether it is appropriate to retain the existing refined methodology to Pillar 2A in its current form.

6.31 Thirteen respondents requested clarification on the future of the refined methodology and expressed concerns regarding the potential increase in capital requirements if the methodology is removed. The PRA considers the refined methodology should be reviewed in light of the changes proposed to the Pillar 1 credit risk framework, and it plans to provide more details when the second near-final PS is published.

Interaction with the strong and simple framework

6.32 Six respondents asked for more clarity on the PRA's Pillar 2 framework under the strong and simple framework. As set out in PS15/23 – **The Strong and Simple Framework: Scope Criteria, Liquidity and Disclosure Requirements**, the PRA intends to publish its proposals on capital-related measures in Q2 2024, which would cover simplifications to Pillar 2.

6.33 Interim Capital Regime (ICR)[34] firms and ICR consolidation entities will be subject to a Pillar 1 framework that is substantially the same as the framework in the Capital Requirements Regulation (CRR), as it applies immediately before the PRA rules to implement the Basel 3.1 standards come into effect.[35] This should apply until the permanent

[33] This will not cover any PRA buffers derived from a risk management and governance scalar.
[34] The 'Interim Capital Regime' is the new name for the 'Transitional Capital Regime' proposed in CP16/22.
[35] In this near-final PS, CRR refers to 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.

risk-based capital framework for Small Domestic Deposit Takers (SDDTs) is implemented. Therefore, the PRA will continue to apply the existing Pillar 2A framework (including the refined methodology) to ICR firms and ICR consolidation entities until the permanent risk-based capital framework for SDDTs is implemented. This means ICR firms and ICR consolidation entities would not be subject to the off-cycle review mentioned above.

Pillar 2 requirements setting process

6.34 Five respondents provided suggestions on the PRA's Pillar 2 requirements setting process, including requests to provide further transparency on the capital setting process and further guidance on the ICAAP.

6.35 As part of the future Pillar 2A methodologies review, the PRA will consider these responses and whether and how to review its Pillar 2 requirements setting process.

7: Currency redenomination

Introduction

7.1 This chapter provides feedback to responses to Chapter 13 of consultation paper (CP) 16/22 – **Implementation of Basel 3.1 standards**, which set out proposals to redenominate certain references to euros (EUR) and US dollars (USD) in the Basel 3.1 standards into pound sterling (GBP) for the purpose of implementation in the Prudential Regulation Authority's (PRA) rules. This chapter also sets out the PRA's near-final policy on currency redenomination following the consultation.

7.2 In CP16/22, the PRA proposed to redenominate thresholds and monetary values expressed in EUR and USD into GBP using the average daily spot exchange rate covering the 12-month period prior to 10 July 2020, rounded to two significant figures: £1 = $1.26 and £1 = €1.14. The PRA proposed to round the resulting GBP thresholds to two significant figures and to revisit thresholds and monetary values only if the average daily spot exchange rates (GBP/EUR or GBP/USD) over the 12-month period prior to the end of the most recent calendar quarter before publication of final rules differed from those set out above by 20% or more.

7.3 The PRA received five responses to its proposals on currency redenomination. The respondents generally asked for increased flexibility to use thresholds in EUR rather than GBP. Having considered the responses, and also having assessed that the spot exchange rate movement is lower than the threshold set out above, the PRA considers that the thresholds and monetary values remain appropriate at this time. Accordingly, the PRA is not making any amendments to its proposals on currency redenomination as specified in CP16/22.

7.4 The PRA's near-final policy on the redenominated thresholds and monetary values, as set out in CP16/22 and described in paragraph 7.2 above, applies to the following new parts of the PRA Rulebook covered in this near-final policy statement (PS):[36]

- Market Risk: Advanced Standardised Approach (CRR)
- Market Risk: General Provisions (CRR)
- Market Risk: Internal Model Approach (CRR)
- Operational Risk
- Credit Valuation Adjustment Risk

[36] As described in Chapter 1 – Overview, this near-final PS does not cover every chapter of CP16/22. The PRA intends to publish a second near-final PS providing feedback to the remaining chapters of CP16/22 in Q2 2024.

Flexibility to apply thresholds denominated in EUR

7.5 Four respondents requested that firms be permitted to use thresholds set in EUR rather than redenominated into GBP. They argued that this would avoid having inconsistent thresholds between the EU and UK rules over time as exchange rates vary.

7.6 The PRA recognises that there may be some small inconsistencies in the long term with EUR thresholds used in EU rules due to exchange rate movements. However, the PRA considers that the potential operational cost of those inconsistencies is outweighed by the benefit to safety and soundness and competition of applying thresholds that are consistent (in GBP-terms) over time and consistent across all PRA-regulated firms.

Use of rounded thresholds

7.7 One respondent requested the PRA use thresholds rounded to one significant figure rather than the proposed two significant figures. The PRA does not consider that this change would significantly decrease the complexity of the rules, and it would be inconsistent with the approach applied by the PRA to thresholds in other regulatory requirements. The PRA therefore considers that the proposed approach to rounding remains appropriate.

PRA objectives and 'have regards' analysis

7.8 The near-final rules are consistent with those in CP16/22 and, therefore, the PRA considers its analysis of its objectives and have regards in CP16/22 remains appropriate.

8: Interim Capital Regime

Introduction

8.1. This chapter provides feedback to responses to Chapter 2 of consultation paper (CP) 16/22 – **Implementation of the Basel 3.1 standards**, which proposed that firms meeting the Small Domestic Deposit Taker (SDDT) criteria would not have to apply the Basel 3.1 standards set out in the consultation paper.[37] On account of this, the Prudential Regulation Authority (PRA) proposed to introduce a Transitional Capital Regime (TCR) that would allow SDDTs to remain subject to existing Capital Requirements Regulation (CRR) [38] provisions until the permanent risk-based capital framework for SDDTs (SDDT capital rules) is implemented.[39] This chapter also sets out the PRA's near-final policy on the TCR following the consultation.

8.2 The PRA received 14 TCR-related comments in response to CP16/22. The respondents generally welcomed the PRA's proposal to introduce an interim arrangement based on the existing CRR capital provisions. However, respondents also sought additional clarification on the process by which firms would opt into the regime and raised concerns over whether the TCR would sufficiently prepare firms for the SDDT capital rules, and the risk of the TCR continuing for a prolonged period.

8.3 In response to the consultation responses, the PRA has decided that the draft rules on the TCR will remain broadly unchanged. This chapter sets out the PRA's feedback to the consultation responses and discusses amendments the PRA has made to the proposed policy and draft rules where it considers appropriate. These amendments are reflected in the Near-final PRA Rulebook: CRR Firms: SDDT Regime (Interim Capital Regime) Instrument [2024] in Appendix 6. The PRA has also made a number of other minor amendments and clarifications to the draft rules, which are not described in this chapter.[40]

8.4 The near-final rules included in Appendix 6 are relevant to UK banks and building societies that expect to meet the SDDT criteria and firms that would wish to be treated in the same way as firms meeting those criteria.

[37] CP16/22 also proposed a revised version of the SDDT criteria consulted on in CP5/22 – **The Strong and Simple Framework: a definition of a Simpler-regime Firm**, to determine the firms that would be eligible to choose (via a modification by consent) to be subject to the Transitional Capital Regime. The final SDDT criteria are detailed in PS15/23.

[38] 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,** which is referred to as the 'CRR' in this PS.

[39] The one exception is rules related to Internal Ratings-based (IRB) Approach. In line with the proposals in CP16/22, the PRA intends to incorporate the Basel 3.1 IRB rules for the ICR.

[40] Where the differences between the final rules and draft rules are not, in the opinion of the PRA, significant, section 138J(5) does not require their inclusion of details of the differences in the policy statement.

8.5 The appendices to this near-final PS contain the PRA's near-final policy, which will:

- introduce a new PRA Rulebook: CRR Firms: SDDT Regime (Interim Capital Regime) Instrument [2024] Part of the PRA Rulebook (Appendix 6); and
- introduce a new statement of policy – Operating the Interim Capital Regime (Appendix 7).

8.6 The policies in this chapter will take effect at the same time as the implementation date for the Basel 3.1 standards.

New naming convention

8.7 In CP16/22, the PRA proposed TCR as the term for the temporary capital arrangement based on existing CRR provisions that will be in force between the implementation dates of the Basel 3.1 standards and SDDT capital rules.

8.8 The PRA has since decided to rename the regime. Although TCR has been effective as a working term, it shares the same acronym with another term widely used in prudential regulation in the UK. Therefore, to avoid confusion, the PRA will now refer to the TCR as the 'Interim Capital Regime' (ICR) in the near-final instrument and statement of policy, and from this point onwards in this policy statement and in future PRA publications.

8.9 The PRA does not consider this name change will affect the PRA's statutory objectives and the PRA's consideration of matters to which it must have regard.

Accountability framework

8.10 As set out in Chapter 1 – Overview, the near-final policy and rules for the ICR 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). Changes to the PRA's accountability framework under the Financial Services and Markets Act 2023 (FSMA 2023) do not apply to the ICR. These provisions are disapplied by regulation 4 of the FSMA 2023 (Commencement No. 2 and Transitional Provisions) Regulations 2023.

8.11 The SDDT criteria (and SDDT consolidation criteria), which determine eligibility for the ICR, have been made in connection with the SDDT regime. The SDDT regime was made in accordance with the changes to the PRA's accountability framework under FSMA 2023 that had been commenced by the time those rules were made.[41] Those changes to the accountability framework do not apply in connection with the ICR. Where relevant, elements

[41] See PS15/23 – **The Strong and Simple Framework: Scope Criteria, Liquidity and Disclosure Requirements** for details.

of the unamended accountability framework that apply to ICR rules have been considered when developing the criteria.

8.12 The PRA considers that the ICR will advance its primary objective to promote the safety and soundness of the firms it regulates while developing a capital regime appropriate for small firms.

8.13 The PRA considers that the ICR would advance its secondary competition objective as it could help small firms minimise the costs associated with multiple changes to capital requirements. It will also give small firms time to assess whether they want to operate under the permanent risk-based capital framework for SDDTs or the capital framework for other firms.

8.14 The PRA considers that the amendments made to the proposed ICR policy and draft rules will not reduce these effects on its primary and secondary competition objective for the reasons set out above. The PRA also does not consider that the impact of these changes will have a different impact on mutuals compared to the consultation draft, nor compared to other PRA-regulated firms.

8.15 The sections below have been structured to group related themes together as follows:

- eligibility for the ICR
- uncertainty regarding the SDDT capital framework
- the process for entering and leaving the ICR
- an alternative implementation approach to the ICR
- scope of application

8.16 For the purposes of this chapter, any references in relation to a firm should, where appropriate, be treated as applicable to both a firm and a CRR consolidation entity.

Eligibility for the ICR

Alignment with the SDDT regime

8.17 In CP16/22, the PRA proposed that a firm that meets the SDDT criteria but does not consent to the modification for joining the ICR would have to implement the Basel 3.1 standards on 1 January 2025. The implementation date for the Basel 3.1 standards has since been moved to 1 July 2025.

8.18 A firm must meet the SDDT criteria to be eligible for the ICR (and the SDDT consolidation criteria must be satisfied for a CRR consolidation entity to be eligible for the ICR). The criteria for becoming an SDDT and ICR firm are aligned because the ICR is meant to benefit firms preparing to be subject to the SDDT capital regime or considering that option.

As a result, the minor drafting changes to the eligibility criteria for the SDDT regime that have been made to the final rules published with PS15/23 will also be relevant to eligibility for the ICR.

8.19 Furthermore, consistent with the approach being taken to SDDT consolidation entities, the near-final ICR rules and statement of policy have been amended to set out that a CRR consolidation entity can become an ICR consolidation entity by way of a modification by consent provided that the SDDT consolidation criteria are satisfied.

Removal of the reference date

8.20 In CP16/22, the PRA proposed that a firm could take up the modification by consent if it met the SDDT criteria on 1 January 2024 (the 'reference date'). Having reflected on the ICR criteria, the PRA considers that the inclusion of a reference date is not necessary to advance the PRA's objectives. The removal of the reference date means a firm needs to meet the SDDT criteria from the date it takes up the ICR modification by consent; likewise an ICR consolidation entity and the SDDT consolidation criteria. This aligns with the approach taken with the SDDT modification by consent, which should make the process for accessing the ICR simpler for firms to understand.

8.21 The PRA considers that the above change to the ICR rules is not significant and will not materially alter the cost benefit analysis (CBA) presented in CP16/22. The PRA is required to comply with several legal obligations when making CRR rules or rules applying to certain holding companies. The above-mentioned changes are minor, to improve the simplicity of the rules and benefit firms by providing further clarity in comparison to the original proposed rules. The PRA also does not consider that the impact of these changes will have a different impact on mutuals compared to the consultation draft, nor compared to other PRA-regulated firms.

PRA objectives and 'have regards' analysis

8.22 The changes are minor to improve the simplicity of the rules and benefit firms by providing further clarity in comparison to the original proposed rules. The near-final rules are aligned with those in CP16/22 and, therefore, the PRA considers its analysis of its objectives and have regards in CP16/22 remains appropriate.

Uncertainty regarding the SDDT capital framework

8.23 The PRA proposed that the ICR would be in place for the period from the implementation date of the Basel 3.1 standards to the implementation date of the SDDT capital rules.

8.24 The respondents were generally supportive of the ICR's overarching objectives. Five respondents caveated their support for the ICR with broader concerns regarding the current uncertainty about the design of the SDDT capital rules. Two respondents called for an expedited consultation date for those capital rules to provide greater certainty.

8.25 One respondent was concerned that the ICR might end up continuing for several years, expressing fears that this risked an adverse divergence with prudential requirements in the EU. The respondent advised the PRA to set out sunset provisions so that the rules underpinning the ICR cease to be effective after their intended end date.

8.26 After considering the responses, the PRA has decided not to change the draft policy. As set out in PS15/23 – **The Strong and Simple Framework: Scope Criteria, Liquidity and Disclosure Requirements**, the PRA intends to consult on a simplified capital framework for SDDTs in Q2 2024 (Phase 2 of the SDDT regime). As part of that consultation paper (CP), the PRA intends to propose how the ICR will end when the SDDT capital regime is implemented. Therefore, firms will be able to compare the Phase 2 proposals with the Basel 3.1 standards when deciding whether to take up the ICR modification by consent. The ICR would be a temporary measure that the PRA does not intend to continue for several years.

PRA objectives and 'have regards' analysis

8.27 The near-final rules are consistent with those in CP16/22 and, therefore, the PRA considers its analysis of its objectives and have regards in CP16/22 remains appropriate.

The process for entering and leaving the ICR

8.28 In CP16/22, the PRA proposed that access to the ICR would be via a modification by consent.

8.29 While they welcomed the ICR, three respondents wanted clarification on this opt-in process, particularly with regards to the timeline for accessing the ICR.

8.30 Firms were unclear as to whether they could later exit the ICR with three respondents thinking that opting into the ICR may irrevocably commit a firm to the SDDT regime. One respondent also questioned how the ICR would accommodate a firm that ceases to meet the SDDT criteria during the period the ICR is in place.

8.31 Having considered the responses, the PRA has decided to publish the draft policy substantively unchanged relative to as proposed, except with respect to the approach to the consolidation entities. The near-final statement of policy – Operating the Interim Capital Regime (Appendix 7) clarifies that eligible entities will be able to choose to be subject to the Basel 3.1 standards by not requesting the modification by consent. Equally, ICR firms that decide to exit the ICR can request that the PRA revoke the modification. If the firm ceases to meet the SDDT criteria, the firm should expect that the PRA will then decide to revoke the modification. The firm would become subject to the Basel 3.1 standards upon the revocation of the modification by the PRA.[42] This is consistent with the PRA proposals set out in CP5/22 – **The Strong and Simple Framework: a definition of a Simpler-regime Firm** and CP16/22.

8.32 The PRA considers the removal of the reference date discussed above will make the process for entering the ICR simpler.

PRA objectives and 'have regards' analysis

8.33 The near-final rules, are aligned with those in CP16/22 and, therefore, the PRA considers its analysis of its objectives and have regards in CP16/22 remains appropriate.

An alternative implementation approach to the ICR

8.34 The PRA proposed that the ICR would be based on existing CRR provisions. This would avoid firms having to apply the Basel 3.1 standards before implementing the SDDT capital rules at a later date. It would also avoid the PRA having to reset Pillar 2A add-ons for firms twice (first for Basel 3.1 standards and again for the SDDT capital regime).

8.35 Two respondents felt the ICR proposals would not sufficiently prepare firms for the SDDT capital regime. The respondents noted that they interpreted CP16/22 as proposing that the risk weights under the SDDT capital rules would ultimately be based on Basel 3.1 standards, which they believed would likely increase capital requirements relative to the existing UK CRR requirements. As a consequence, the respondents advocated for a 'glide path' approach for the ICR to aid ICR firms' transition to the SDDT capital rules, which would gradually transition firms from the CRR to the SDDT regime rules, to aid ICR firms' transition to the SDDT capital rules.

8.36 Having considered the responses, the PRA has decided not to incorporate a glide path into the draft ICR rules and policy. The PRA considers that the additional costs would not be commensurate to the benefits if the ICR was applied as a glide path. A glide path would likely introduce complexity for eligible firms, which would have to incur the costs involved in understanding and operationalising the glide path, for a regime that is ultimately temporary.

8.37 The ICR also affords eligible firms flexibility; another respondent commented that the ICR afforded firms time to assess whether they wish to adopt the Basel 3.1 standards (on 1 July 2025) or join the SDDT regime when it is implemented.

[42] If a firm ceases to meet the SDDT criteria, they must notify the PRA of the fact within 14 days.

PRA objectives and 'have regards' analysis

8.38 The near-final rules are aligned with those in CP16/22 and, therefore, the PRA considers its analysis of its objectives and have regards in CP16/22 remains appropriate.

Scope of application

8.39 For the ICR, the PRA intends to make rules to replace the CRR articles and technical standards that HM Treasury (HMT) revokes, in order to preserve their effect as appropriate for firms meeting the SDDT criteria. The PRA does not intend to change the policy or make substantive alterations to the ICR instrument before the making of the final policy material. The near-final rule instrument (Appendix 6) contains the first iteration of near-final ICR rules relating to market risk and operational risk.

8.40 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 SDDT criteria but could apply for a modification of the criteria that would enable it to be subject to the ICR. The near-final statement of policy included in Appendix 7 sets out circumstances in which the PRA might grant a modification to the SDDT criteria (subject to the statutory conditions being met) that would enable a firm that is part of a group based outside of the UK to consent to the modification for joining the ICR.

8.41 The near-final statement of policy included in Appendix 7 also sets out the modification-by-consent process by which firms become ICR firms and CRR consolidation entities become ICR consolidation entities.

8.42 Respondents were generally supportive of the proposal for ICR firms and ICR consolidation entities to be removed from the Basel 3.1 standards' scope of application.

8.43 One respondent asked that the PRA recognise that there are larger firms that do not meet the SDDT criteria that are non-systemic. While this comment is not specifically related to the ICR, CP4/23 noted the PRA is considering whether and how to build out other layers of the Strong and Simple Framework for larger firms that are not internationally active.

PRA objectives and 'have regards' analysis

8.44 The near-final rules are aligned with those in CP16/22 and, therefore, the PRA considers its analysis of its objectives and have regards in CP16/22 remains appropriate.