WHISTLEBROOK

JANUARY 2026

WHISTLEBROOK'S CONSIDERATIONS ON BASEL 3.1

Whistlebrook: Basel 3.1 PRA Policy Statements 17-23 and 9-24

EXECUTIVE SUMMARY

This paper outlines Whistlebrook's review of the Basel 3.1 regulation that is to be effective from 1st January 2027. Whistlebrook's WIRES customers may wish to consider the information in this paper, in terms of its implications on regulatory calculations and reporting.

Basel 3.1 will be applicable to banks, building societies and PRA regulated investment firms, all of whom do not satisfy the criteria of the 'Small Domestic Deposit Takers' (SDDT) regime. Those institutions that do meet the SDDT conditions required by that classification, will have a choice of being subject to Basel 3.1 or the SDDT Framework.

The criteria to be an SDDT firm[1] are detailed in the Regulatory Choice part of this document

Basel 3.1 will introduce changes relative to the existing Capital Requirements Regulation (CRR) and affect many parts of Pillar 1. There are notable alterations to credit risk requirements for most exposure classes, including retail and residential mortgages. Regulatory reporting and disclosures will also be impacted.

Whistlebrook provides no warranty that the information described within this paper is complete or without error or inaccuracy. The paper has been prepared for the sole purpose of supporting WIRES customers in understanding Basel 3.1 and in completing their own analysis of the impacts.

[1] Institutions that meet the SDDT criteria and do not wish to be subject to Basel 3.1, must apply to the PRA for a 'modification by consent'.

CONTENTS

REGULATORY CHOICE

A firm that meets all the following criteria will be able apply for a modification, should it wish to be subject to the rules of SDDT. The alternative is Basel 3.1. Full details of the criteria are listed below.

Asset Size	Maximum of £20bn (average over 36 months)
UK Focussed	a. UK located exposures / All known locations exposures > = 75% (AT ALL TIMES) exc. Exposures to governments, central banks, other financial institutions, multi-lateral development banks e.g. European Investment Bank AND b. Where country specific data have been reported in COREP C 09.04, the average (using submitted data in the previous 36 months), percentage of UK exposures relative to All, > = 85% Exposures Definition: Credit exposures are the original exposure amount as reported in rows 0010, 0020, 0030, 0040 and 0055 of C 09.04. The exposures are: • credit risk • trading book exposures • securitisation positions in the banking book
Internal Models for credit risk	None

No or limited trading books	Limited means: On and off balance sheet trading book business must not exceed both (last day of at least one month in previous three; or minimum of six out of prior twelve) a. 5% of the firm's total assets b. AND GBP 44million
Foreign exchange and commodities	No commodity positions Foreign exchange position must not exceed 3.5% of own funds. If that limit has not been breached, then the following condition must be satisfied. The average daily net position relative to own funds does not exceed 2% (in at least one month out of previous three OR six of prior twelve).
Clearing	No clearing (cheques, faster payment, etc) and settlement services provided. Clearing is typically done by the large 'clearing banks'.

SDDT and Basel 3.1 regulations will both commence on 1st January 2027.

Policy statement 9-24 noted that the PRA will provide at least six weeks for firms to contact it to request a Modification by Consent, before the Basel 3.1 effective date.

BASEL 3.1

The Basel 3.1 rules will supersede the existing 'Capital Requirements Regulation' (CRR) for those firms that do not satisfy the criteria to be an SDDT type. Basel 3.1 can also apply to entities that qualify as SDDT but choose not to be subject to it. The effective date of Basel 3.1 is 1st January 2027. Therefore, regulatory returns for report reference date 31st December 2026, will not be under the Basel 3.1 requirements.

The reasons for implementation of Basel 3.1 are mainly to:

- Make the regulation more risk sensitive, particularly for residential mortgages
- Require more frequent due diligence and have less ridgid reliance on external credit ratings
- Reduce inconsistencies between firms' risk exposure amounts derived using internal models, rather than the regulator's standardised approach
- Introduce a floor on aggregate Pillar 1 risk weighted exposures calculated using the Internal Models, rather than that specified by the regulator.

In the remainder of this document, there are references made to chapters. These are in the PRA's consultation paper 16-22 and in policy statements 17-23 and 9-24.

CHANGES INTRODUCED BY POLICY STATEMENT 9-24

Policy Statement 9-24 was published with the final Basel 3.1 requirements for credit risk and its mitigation; Output Floor; reporting and Pillar 3 disclosures. The policy introduced new requirements and made changes relative to those proposed in Consultation Paper 16-22. The details are summarised below.

Area	Latest Requirement
STANDARDISED APPROACH TO CREDIT RISK	
Retail Exposures	It has been clarified that the following are excluded from the total amount owed when assessing qualification as a retail exposure. a. Undrawn commitments b. Residential real estate exposures c. Commitments to issue off balance sheet items
Modification by Consent	The PRA will provide at least six weeks for firms to contact it to request a Modification by Consent (for entities that meet the criteria to be a small domestic deposit taker), before the Basel 3.1 effective date.
Regulatory Residential Real Estate	Unfinished self-build properties will be included in 'Regulatory Residential Real Estate', rather than in 'Other Residential Real Estate'.
	It has been clarified that an exposure secured on a second charge can be treated as regulatory residential real estate.

	The proposal that holiday lets, care homes and purpose built student accommodation not qualify as residential real estate collateral, has been removed.
	Property revaluations will be required once every five years (or three, where the loan is more than £2.6million or above 5% of the firm's own funds). All residential property collateral will require a revaluation within five years (or less) of the Basel 3.1 start date.
	'Material Dependence' – All exposures will fall into this category, unless at least one of four conditions are met.
	Three Property Limit – An exposure secured on the borrower's property in which he resides, will not be part of the portfolio. That exposure will not be materially dependent.
	Self build property – The value of this collateral associated with an exposure is defined as follows. Max (Land Value, Most recent valuation of the property less 20%)
	Residential Real Estate Materially Dependent – The LTV buckets have been revised by splitting the '60% < LTV <= 80%' into two. Risk weights of 40% and 50%, rather than 45%, will apply.
	Currency Multiplier – Confirmation provided that 'Other Residential Real Estate' exposures will also have the unhedged currency multiplier rule.

	Currency Multiplier – For exposures to individuals, the country of employment of the borrower can be used to identify presence of an unhedged position. This data item is an alternative to the currency of the borrower's main income.
Regulatory Commercial Real Estate Exposures	Material Dependence has been defined. Material dependence will apply *unless* the secured property is *predominantly used for the borrower's own business*
	Rules for commercial real estate exposures to Small & Medium Sized Enterprises, have been introduced.
	The proposed 100% risk weight floor on non-materially dependent exposures has been removed.
Retail Exposures	Qualification Criteria – It has been confirmed that undrawn commitments must be excluded when assessing if an exposure can be classified as 'Retail'.
	Qualification Criteria – It was stated that consideration of annual revenue of an SME can be restricted to those entities within the accounting consolidation of the borrower.
	Currency Multiplier – For exposures to individuals, the country of employment of the borrower can be used to identify presence of an unhedged position. This data item is an alternative to the currency of the borrower's main income.
Equity Exposures	A revised standardised approach is being introduced.

INTERNAL RATINGS BASED APPROACH TO CREDIT RISK (IRB)	
Institution Exposures	Those allocated to the 'Quasi Sovereigns' class, must be risk weighted under the standardised approach to credit risk and not IRB.
Collective Investment Undertakings (CIUs)	Units or shares in CIUs will not be part of the Equities exposure class.
Output Floor	The floor level as a percentage of risk weighted exposures according to the standardised approach to credit risk, during the transition period, have been revised. The calculation of the floor has been updated to include the effect of provisions.

CREDIT RISK STANDARDISED APPROACH – CHAPTER 3

Calculation of credit risk weighted exposures using the standardised approach will be changed relative to CRR, across most exposure classes.

SOVEREIGN EXPOSURES

The risk weight associated with a central government will not be allowed to be applied to exposures to other public sector entities.

In the case of exposures to regional and local governments, the following treatments will apply:

a. Credit rating not available for regional or local government

   - Use the credit rating of the related central government.

b. Credit rating not available for regional or local government or related central government

   - Exposures should be risk weighted at 100%.

EXPOSURE CLASS – RESIDENTIAL REGULATORY REAL ESTATE

There are several key elements being introduced by Basel 3.1:

1. Conditions to be a Real Estate Exposure

- Fully built
  A change was introduced by Policy Statement 9-24 to allow unfinished self-build properties to be included in 'Regulatory Real Estate', rather than in 'Other Real Estate'. The self-builds must satisfy the following characteristics.

  a. Property purchased or held for development purposes
  b. There are not OR will never be more than four residential houses
  c. The property will become the borrower's primary residence.

- No legal disputes over the rights to the property

- Prudently valued and not linked to the performance of the borrower

- Charge
  Secured by a charge over the property. Policy Statement 9-24 did clarify that a second charge can be treated as regulatory real estate.

- Property is to be usable as a standard residential dwelling, only.
  Policy statement 9-24 removed the proposal that holiday lets, care homes and purpose built student accommodation cannot qualify as residential real estate collateral.

- Insurance of the secured property must be adequate

- Borrower's ability to repay has been assessed

2. Property Revaluation

Policy Statement 9-24 introduced rules on property revaluations, meaning that reassessment is required once every five years (or three, where the loan is more than £2.6million or above 5% of the firm's own funds).

Where there is a general decrease in market prices, a downward revaluation will be required where it is estimated that the property value has decreased by more than 10% since the last valuation.

As a result, all secured properties will require to have been revalued within five years (or three in the case described above) of the Basel 3.1 implementation date.

3. Material Dependence

Policy Statement 9-24 introduced the way in which material dependence is to be applied. *All Residential Real Estate exposures are to be classified as materially dependent on cash flows generated from the secured property, unless one or more of the following applies.*

a. The exposure is to an individual and is secured by a single property that is the borrower's primary residence.

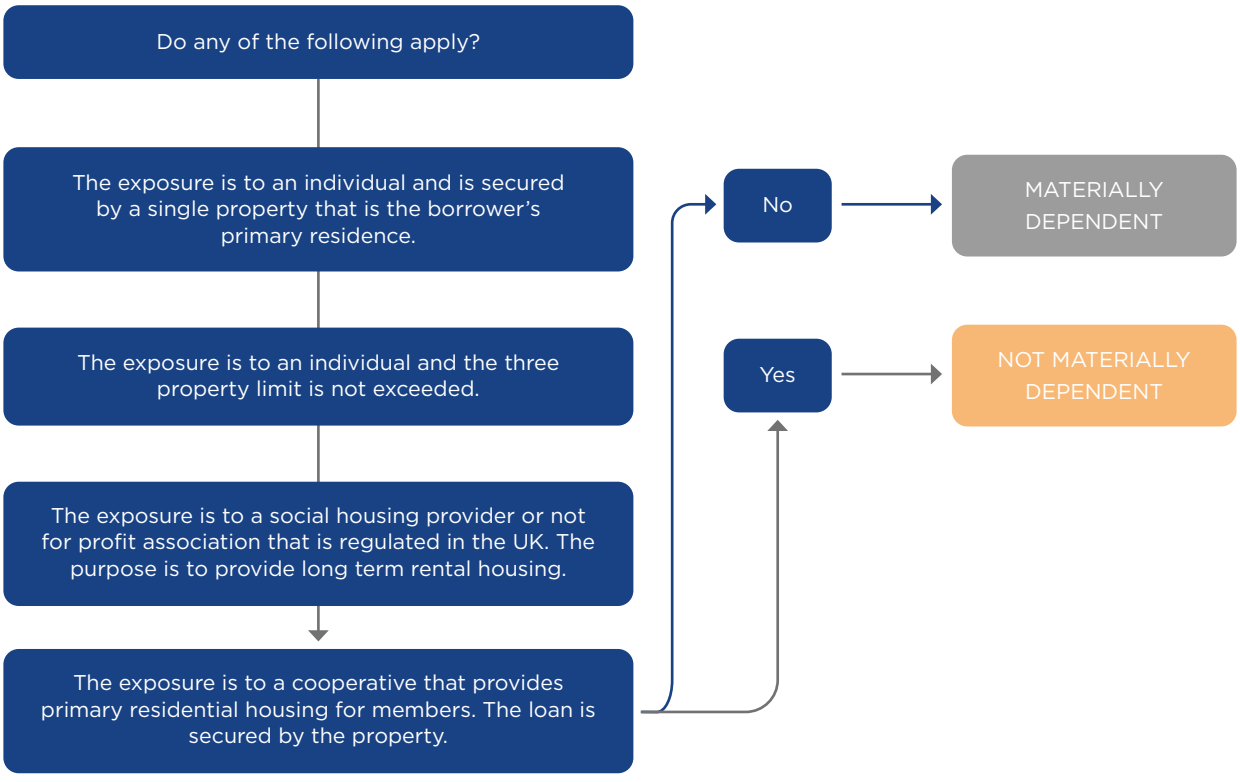
b. The exposure is to an individual and the three property limit is not exceeded. This assessment will be done at refinancing (e.g. moving to a different product at the end of another's life) or at the loan's origination.

c. The exposure is to a social housing provider or not for profit association that is regulated in the UK. The purpose is to provide long term rental housing.

d. The exposure is to a cooperative that provides primary residential housing for members. The loan is secured by the property.

4. House of Multiple Occupancy (HMO)

Policy Statement 9-24 replaced the proposed treatment that residential real estate exposures be treated as materially dependent. Unless at least one of the conditions that would preclude material dependence, is met, then a residential real estate exposure secured on property of multiple occupancy, will be classed as materially dependent. HMO is a property occupied by at least 3 unrelated people.



5. Three Property Limit

Policy Statement 9-24 will introduce a rule that means a residential real estate exposure secured by the borrower's primary residence, will not be included in the portfolio considered for the Three Property Limit. That is a change relative to the treatment proposed in consultation paper 16-22.

Other Key Points:

a. Single housing unit (e.g. an annex) that is a separate part of a main house, must be counted as one.
b. If the borrower is using more than three properties (excluding his primary residence) as security for residential real estate loans, all exposures must be treated as materially dependent.

6. Self Build Property Valuation

Policy Statement 9-24 introduced a method to value the collateral associated with an exposure secured on self-build property.

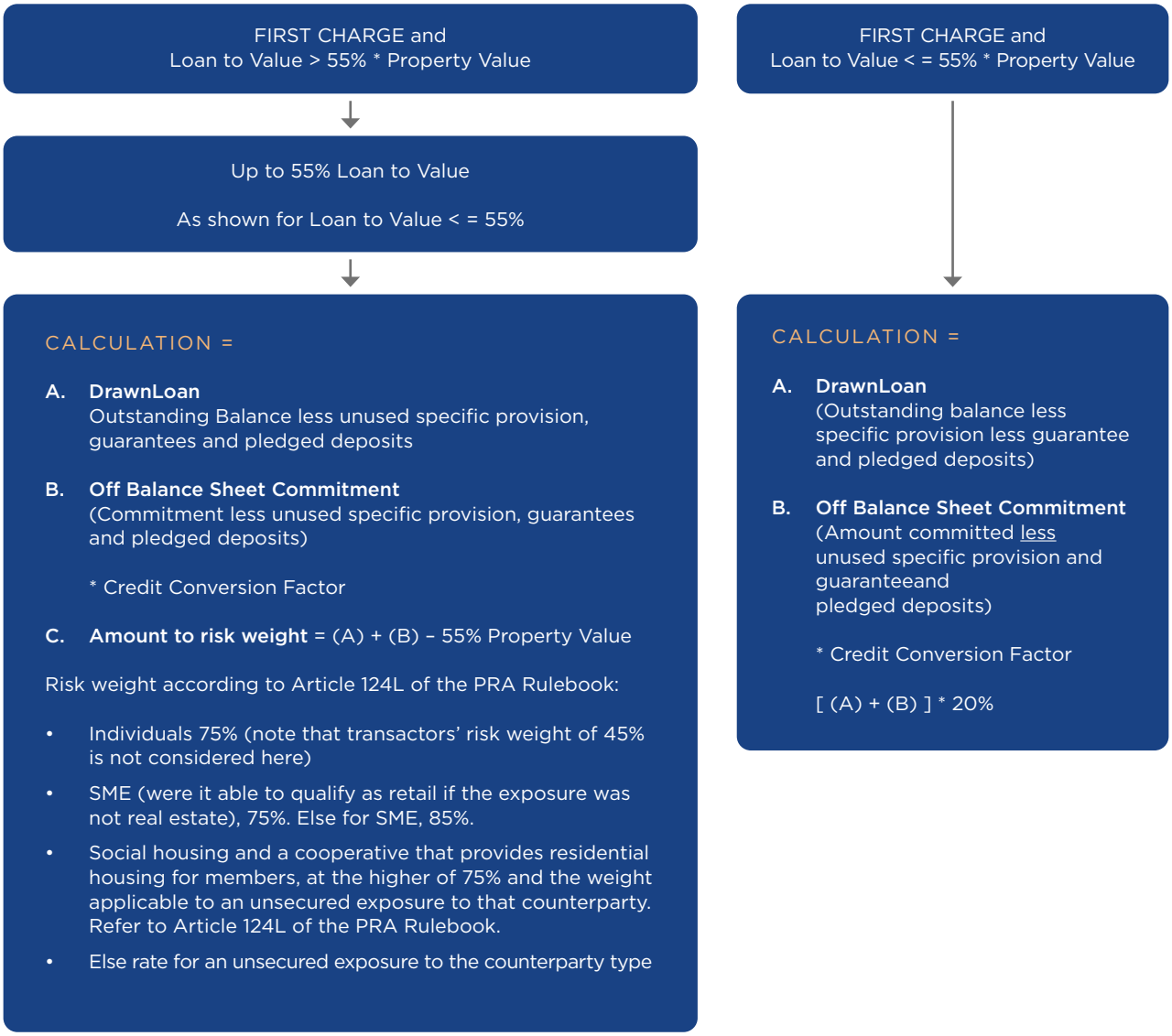
Value = Max (Land Value, Most recent valuation of the property less 20%)

7. Materially vs Not Materially Dependent

Risk weights to be used to calculate the exposure amount for own funds purposes, will depend on loan to value and the extent to which there is dependence on income generated from the property.

Case 1 – Not Materially Dependent on income generated from the secured property

The calculation to get the risk weighted exposure is detailed in the following flowchart.



LTV = [Gross outstanding balance + undrawn committed amount of that loan – deposits pledged to the lender and can be subject to on balance sheet netting] / Property Value

For risk weighting, it is also expected that a guarantee received and any pledged deposits, will be deducted at the same time as specific provision.

Exposures to social housing will be included as 'not materially dependent on income from the property'. Any part deemed unsecured will be risk weighted at the higher of 75% and the weight applicable to an unsecured exposure to that counterparty.

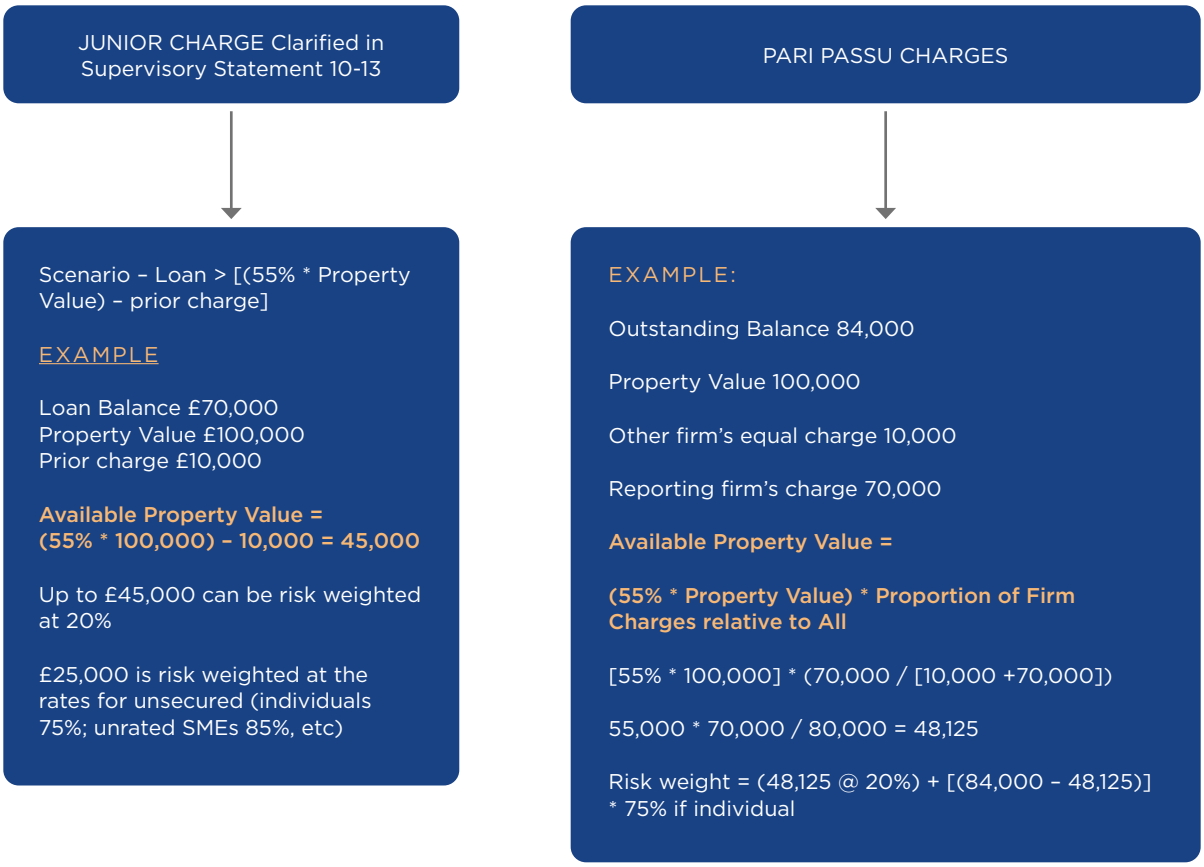
Unhedged Currency Position
A currency multiplier of 1.5 will apply to the risk weight, where there is an unhedged mismatch between the currency of the funds servicing the borrower's debt and that of the loan. Exposures within the Retail and Residential Mortgage Real Estate are subject to this multiplier. Policy Statement 9-24 confirmed that 'Other Residential Real Estate' exposures will also have the multiplier applied in the above circumstances.

The multiplier is relevant to exposures to individuals and an entity created to fund immovable residential property, with an individual as guarantor (in receipt of some benefit).

When the currency multiplier is to be used, the Risk Weighted Exposure Amount (RWA) becomes

RWA = RWA pre-multiplier * 1.5

It is possible that the lender does not have an exclusive first charge on the secured property. The following diagrams show the treatment when there is a prior charge and a Pari Passu claim.



Case 2 – Materially Dependent on income generated from the secured property

Materially Dependent is where none of the characteristics detailed earlier within the 'Residential Regulatory Real Estate' part of this paper, are met. This definition was introduced by Policy Paper 9-24.

In some cases, as described above, the 'Three Property Limit' can result in material dependence.

Calculations for Risk Weighted Exposures with Material Dependence

The risk weight to be used will be taken from the screenshot below.

Calculation of Risk Weighted Amount:

(A) = [(outstanding balance less specific provision – guarantee – pledge deposit)] +

(B) = [Off Balance Sheet Commitment – unused specific provision – unused guarantee – unused pledged deposit] * Credit Conversion Factor

(C) = (A) + (B)

(C) * Risk Weight from table below

Where LTV exceeds 50% and the lender does not have a first charge, then a multiplier of 1.25 is required in the above calculation. There will also be a currency multiplier of 1.5 (applicable where there is an unhedged mismatch between the currency of the funds servicing the borrower's debt and that of the loan). Further detail on that multiplier is the non-materially dependent section.

LTV = [Gross outstanding balance + undrawn committed amount of that loan – deposits pledged to the lender and can be subject to on balance sheet netting] / Property Value

Risk Weights for Residential Estate

(Materially Dependent on cash flows generated by the property)

	LTV Buckets						
	<=50%	50% < LTV <= 60%	60% < LTV <= 70%	70% < LTV <= 80%	80% < LTV <= 90%	90% < LTV <= 100%	LTV > 100%
Risk Weight	30%	35%	40%	50%	60%	75%	105%

Policy Statement 9-24 revised the LTV buckets by splitting the '60% < LTV <= 80%' into two. A risk weight of 45% had been proposed for this bucket. The final risk weights are shown above.

Other Residential Real Estate

If a residential mortgage exposure does not satisfy the conditions to be 'Residential Real Estate', then it is risk weighted according to the table below.

TYPE	TREATMENT
Residential – Not Materially Dependent	Risk Weight Use the risk weight for the counterparty. Refer to Article 124L of the PRA Rulebook. • Individual – 75% • SME – if the exposure was not real estate and could qualify as retail, then 75%. Else for the SME, 85% Multiplier A currency multiplier will also be required where there is an unhedged exposure to an individual or an entity created to fund immovable residential property. Charges – Prior and Pari Passu The PRA Rulebook (Article 124J) makes no reference to treatment for prior or pari passu charges.
Residential – Materially Dependent	Risk Weight At 150% Multiplier A currency multiplier will also be required where there is an unhedged exposure to an individual or an entity created to fund immovable residential property. Charges – Prior and Pari Passu The PRA Rulebook (Article 124J) makes no reference to treatment for prior or pari passu charges.

Off Balance Sheet – Residential Mortgage Pipeline

Pipeline exposures would be included in this exposure class in the same way as a loan already drawn i.e.

*(Amount undrawn – provisions and adjustments – guarantees and pledge deposits) * Credit Conversion Factor = Amount to be risk weighted*

Offers will have a credit conversion factor of 50%. Under Capital Requirements Regulation, such an exposure would have a credit conversion factor of 20% (maturity less than one year), else 50%.

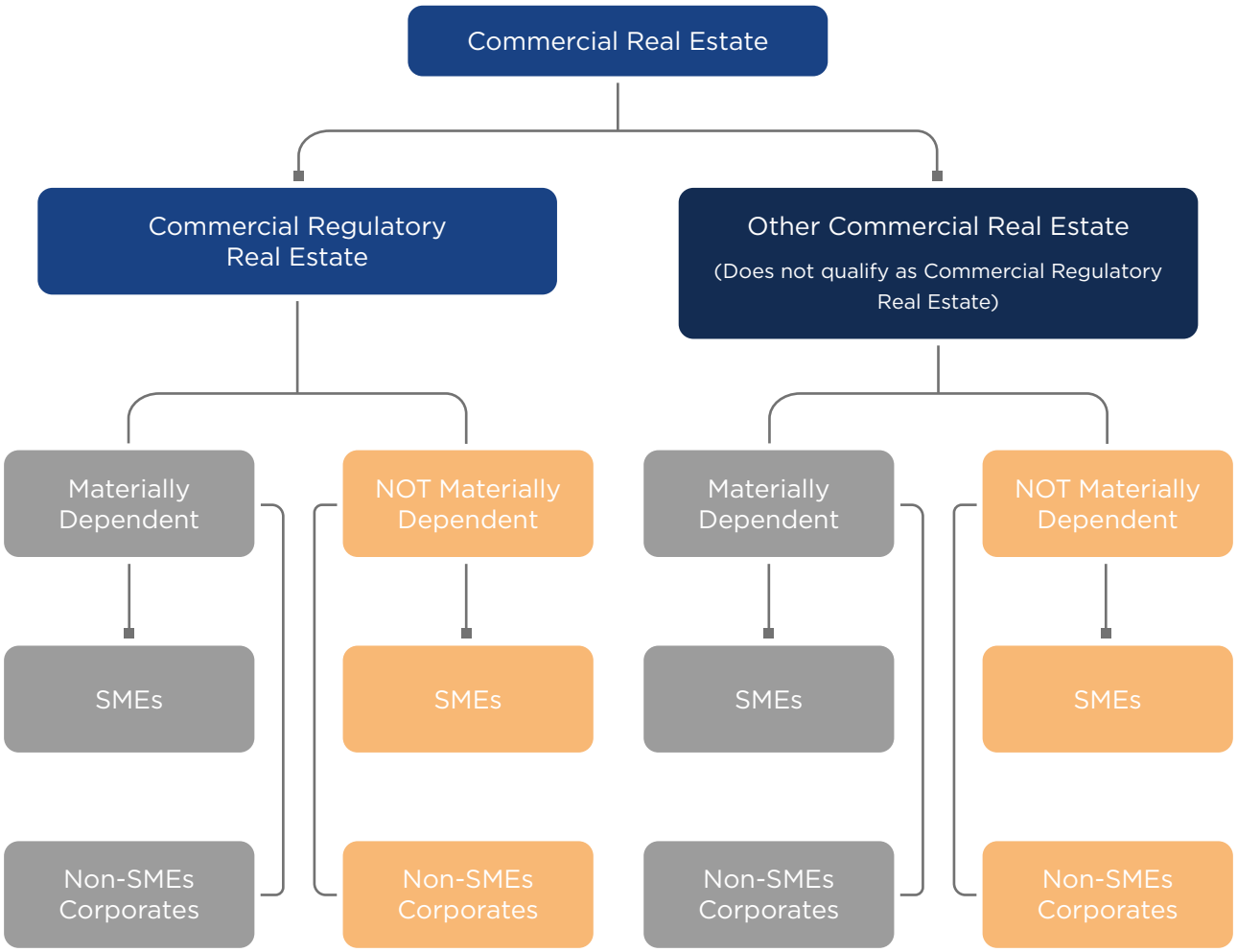
EXPOSURE CLASS – COMMERCIAL REGULATORY REAL ESTATE

Policy Statement 9-24 defined when an exposure can be considered as 'materially dependent' on the cash flows generated by the secured commercial property.

The PRA stated that an exposure that is secured on commercial real estate will be treated as materially dependent, unless the property is predominantly used for the borrower's own business.

For example, where the secured property is rented out (to generate additional income) by the borrower, rather than being used for his own business, the exposure will be treated as materially dependent.

Policy Statement 9-24 introduces rules for commercial real estate exposures to Small & Medium Sized Enterprises. The structure for commercial exposures is in the following diagram.



Case 1 – Commercial Regulatory Real Estate: NOT Materially Dependent

Policy Statement 9-24 removed the proposed risk weight floor of 100%. The final calculations are below.

INDIVIDUAL; SME	NON-SME
Risk Weight (60% * Up to 55% of the property value) + (counterparty risk weight * residual amount above 55%) **Counterparty risk weight** according to Article 124L of the PRA Rulebook: • Individual 75% • If the SME exposure was not commercial real estate and would otherwise qualify as Retail, then 75%. • Non-qualifying SME 85% **Charges – Prior and Pari Passu** The 55% value is reduced by prior charges and apportioned according to the relative pari passu.	**Risk Weight** Max (60%, min [risk weight for an unsecured exposure to the counterparty, risk weight were the exposure materially dependent on cash flows generated by the property]) **Charges – Prior and Pari Passu** The PRA Rulebook (Article 124H) makes no reference to treatment for prior or pari passu charges.

Case 2 – Commercial Regulatory Real Estate: Materially Dependent

The risk weights in this category are below.

INDIVIDUAL; SME	NON-SME
Risk Weight a. LTV <= 80% then RW at 100% b. LTV > 80% then RW all at 110% **Prior Charges** Where prior charges are present, risk weighting becomes: • LTV <= 60%, RW at 100% • 60% < LTV <= 80%, RW at 125% • LTV > 80%, RW at 137.5%	**Risk Weight** a. LTV <= 80% then RW at 100% b. LTV > 80% then RW all at 110% **Prior Charges** Where prior charges are present, risk weighting becomes: • LTV <= 60%, RW at 100% • 60% < LTV <= 80%, RW at 125% • LTV > 80%, RW at 137.5%

Other Commercial Real Estate

This category covers loans secured on commercial real estate that do not satisfy the criteria to be classed as 'Commercial Regulatory Real Estate'.

Case 1 – Not Materially Dependent

The risk weights in this category are below.

INDIVIDUAL; SME	NON-SME
Risk Weight Max (60%, risk weights according to Article 124L of the PRA Rulebook) Counterparty risk weight according to Article 124L of the PRA Rulebook: • Individual 75% • If the SME exposure was not commercial real estate and would otherwise qualify as Retail, then 75%. • Non-qualifying SME 85%	Risk Weight Max (60%, the weight for unsecured lending to the counterparty)

Case 2 – Commercial Regulatory Real Estate: Materially Dependent

The risk weights in this category are below.

INDIVIDUAL; SME	NON-SME
Risk weight at 150%	Risk weight at 150%

MIXED REAL ESTATE EXPOSURES

Article 124 paragraph 4 of the PRA Rulebook introduced the treatment for exposures where they are secured on residential and commercial premises e.g. a property that has a shop on the ground floor and residential dwellings elsewhere.

This exposure is split into residential and commercial, according to the relative values of the collateral.

The possible scenarios with mixed real estate exposures are:

a. Both parts qualify as regulatory real estate

   The rules for 'Residential Regulatory Real Estate' and 'Commercial Regulatory Real Estate' will apply.

b. Both parts do NOT qualify as regulatory real estate

   The exposure will be split into 'Other Residential Real Estate' and 'Other Commercial Real Estate'.

EXPOSURE CLASS – LAND ACQUISITION, DEVELOPMENT AND CONSTRUCTION

These are exposures to companies or special purpose entities, where the loans are to finance residential or commercial property. This is a new exposure class.

An exposure not linked to residential property is risk weighted at 150%, else at 100%.

EXPOSURE CLASS – RETAIL

Two sub-classes are being introduced:

- Transactors risk weighted at 45% – overdraft not drawn on over the past 12 months; credit card balances always repaid prior to minimum payment date
- Non-transactors risk weighted at 75%

SME Supporting Factor

The factor that can be applied to Small & Medium Sized Enterprises risk weighted exposure amounts under CRR, will not be available under Basel 3.1.

Retail Criteria

Qualification criteria as a retail exposure are amended slightly, such that they specify product type. Exposures need to be through:

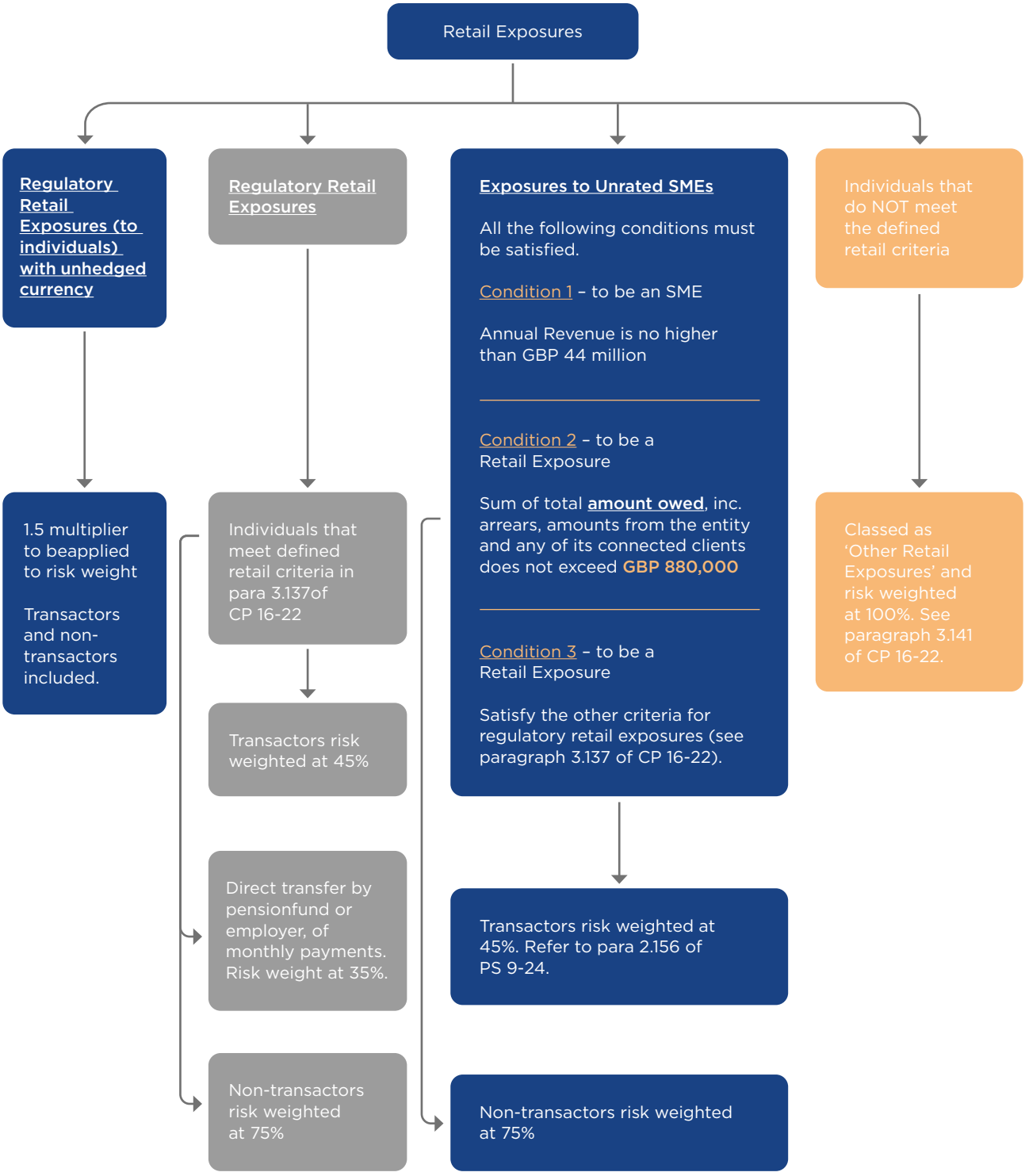
- Overdrafts
- Credit / charge cards
- Personal loans and leases
- Commitments to SMEs (understood to include any undrawn limit)
- Outstanding amount does not exceed GBP 880,000. This item has not changed relative to CRR.

(Refer to paragraphs 3.136 and 3.137 of PRA CP 16-22)

Allocation of SMEs to Retail Exposures

Policy Statement 9-24 clarified that undrawn commitments must be excluded when assessing if an exposure can be classified as 'Retail'.

This policy statement stated that consideration of annual revenue of an SME can be restricted to those entities within the highest accounting consolidation of the borrower (in its jurisdiction). Only annual turnover is considered (when determining the exposure classification) for the standardised and internal ratings based approaches to credit risk.


Retail Exposures
Regulatory Retail Exposures (to individuals) with unhedged currency
Regulatory Retail Exposures
Exposures to Unrated SMEs
All the following conditions must be satisfied.
Condition 1 – to be an SME
Annual Revenue is no higher than GBP 44 million
Condition 2 – to be a Retail Exposure
Sum of total amount owed, inc. arrears, amounts from the entity and any of its connected clients does not exceed GBP 880,000
Condition 3 – to be a Retail Exposure
Satisfy the other criteria for regulatory retail exposures (see paragraph 3.137 of CP 16-22).
Individuals that do NOT meet the defined retail criteria
1.5 multiplier to beapplied to risk weight
Transactors and non-transactors included.
Individuals that meet defined retail criteria in para 3.137of CP 16-22
Classed as 'Other Retail Exposures' and risk weighted at 100%. See paragraph 3.141 of CP 16-22.
Transactors risk weighted at 45%
Direct transfer by pensionfund or employer, of monthly payments. Risk weight at 35%.
Non-transactors risk weighted at 75%
Transactors risk weighted at 45%. Refer to para 2.156 of PS 9-24.
Non-transactors risk weighted at 75%

Unhedged currency mismatch is where the individual's main income is in a different currency to the exposure.

Given the introduction of the following, there is likely to be a need for additional data to be collected.

- Transactors
- Non-transactors
- Individuals that do not satisfy all criteria to be a true retail exposure
- Treatment for unhedged currency mismatch exposures to individuals

Currency Mismatch Multiplier

To identify the presence of an unhedged currency mismatch, firms may wish to collect the following data items:

- The currency of an individual's main income. A comparison against the currency of the loan, would then be made.
- Introduced in Policy Statement 9-24: As an alternative, the country of employment of the borrower. Where that country is abroad, may highlight an unhedged position.

Residential Mortgages and Retail Exposures

There is nothing in the consultation paper or policy statement that suggests the amount of a residential mortgage exposure that is above 55% LTV, should be classed as Retail. It is correct that the excess will get risk weighted at 75% (for individuals). That weight is the same as in the Retail exposure class (non-transactors), but it does not mean that such residential exposures are reclassified.

The above comment applies to residential mortgages that do not have a material dependence on income generated from the secured property.

EXPOSURE CLASS – CORPORATES

Specialised Lending exposures will be reported as a separate class and no longer included in Corporates.

Case 1 – Externally Credit Rated Exposure

Relative to CRR, the risk weights linked to 'credit quality step' are being slightly amended to become those below.

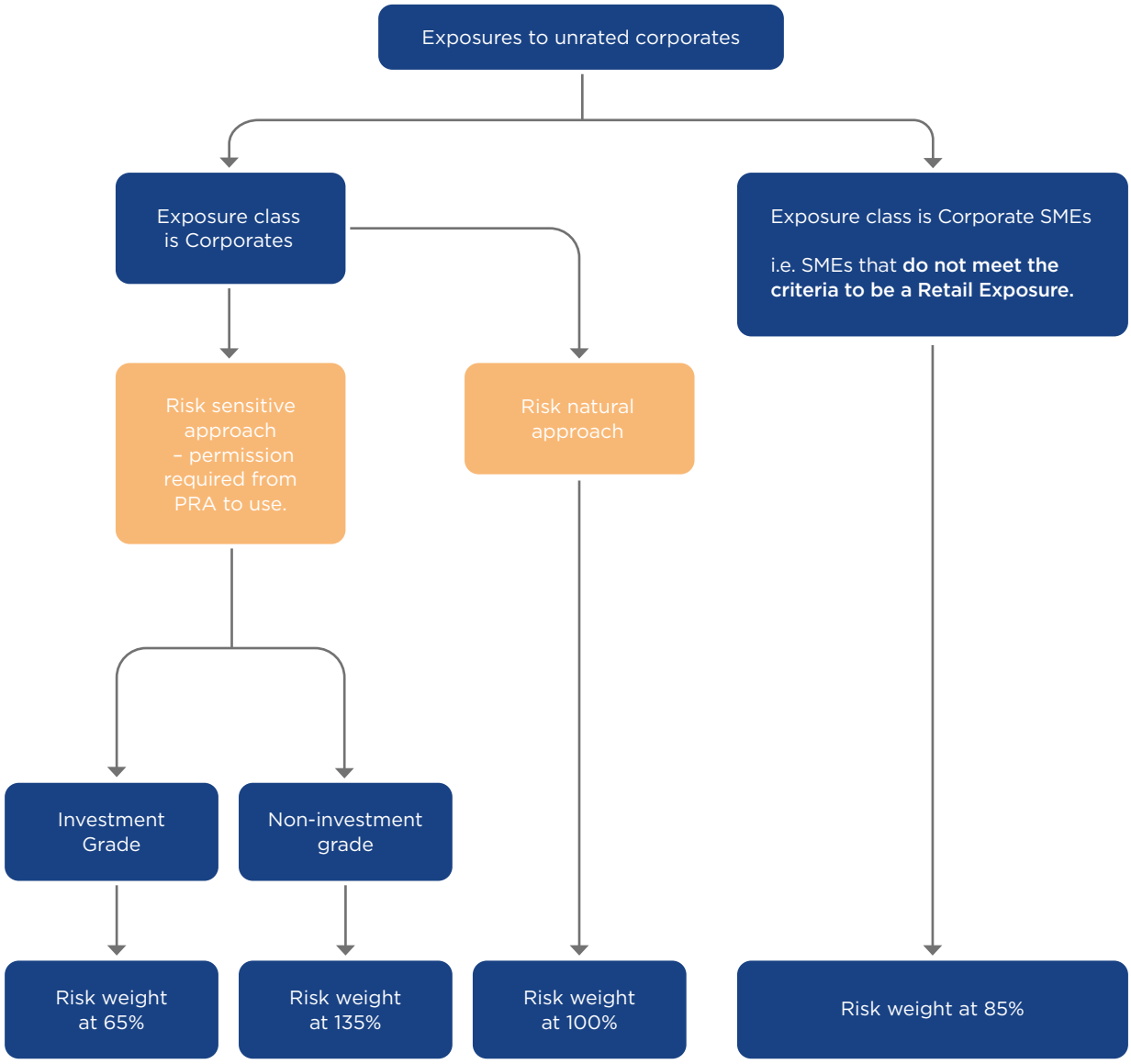
CQS 1	CQS 2	CQS 3	CQS 4	CQS 5-6
Proposed treatment for externally rated corporates				
20%	50%	75%	100%	150%

Case 2 – Unrated Exposure

Basel 3.1 will introduce new Corporate sub-classes:

- Investment grade
- Non-investment grade
- Corporate SMEs

The risk weights that need to be applied to such unrated exposures are as shown in the following diagram.



A firm will require permission to apply the risk sensitive approach (available where the firm is deemed to have the ability to assess the exposure accurately). Where the latter cannot be used, a 'risk neutral' approach should be applied.

'Investment Grade' means that the corporate (to which there is an exposure) has the ability to meet its financial obligations in a timely manner, even where the economic cycle becomes less favourable.

Corporate SME

According to footnote 29 of CP 16-22, a Corporate SME is an SME (no credit rating) that does not satisfy the criteria to be a retail exposure. One of those conditions is that its annual turnover is no higher than £44million. Refer to footnote 29 in chapter 3 of CP 16-22. Number of employees and asset size are not considered under Basel 3.1, but were in the Capital Requirements Regulation.

SME Supporting Factor

The factor used to reduce the risk weighted exposure to SMEs, will not apply under Basel 3.1.

Change Introduced by PS 9-24: A firm specific 'SME Lending Adjustment' will be introduced and be applied to Pillar 2A capital. The aim is to make the overall capital requirement for SME exposures unchanged from that in the Capital Requirements Regulation.

EXPOSURE CLASS – SPECIALISED LENDING

Basel 3.1 will introduce a specific treatment for specialised lending. Exposures of this nature will include infrastructure and commodities finance.

The infrastructure supporting factor in CRR, that reduces the risk weighted exposure by 25%, will not be available for these exposures (and more generally) under Basel 3.1.

There will be three sub-classes within specialised lending:

- Object Finance
- Commodities Finance
- Project Finance

Case 1 – Externally Credit Rated Exposure

The risk weighting to be applied to an exposure, will require the 'Credit Quality Step' value, as indicated below.

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

Case 2 – Non externally rated exposure

A. Object and Commodities Finance

Risk weight at 100%.

B. Project Finance

Exposures will get allocated to either 'pre-operational' or 'operational' and risk weighted accordingly.

a. 'Operational' applies only where there is a positive net cash flow with all the contractual obligations covered and a declining long term debt.

The exposure is required to be allocated to either 'High Quality' or 'Not High Quality'.

Definition 'High Quality':
The counterparty is considered robust, able to meet its obligations in a timely manner even where there is an economic downturn and the lender's credit protection is satisfactory.

Risk Weighting:

- 'High quality' at 80%
- Else 100%

b. 'Pre-operational' to be risk weighted at 130%.

EXPOSURE CLASS – INSTITUTIONS

Externally Credit Rated

Exposures to institutions that are credit quality step 2, will be risk weighted at 30% (was 50% under CRR).

Exposures with a residual maturity of three months or less, cannot be risk weighted at less than 20%.

The risk weights firms will be required to use with exposures to other institutions are shown below.

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

Unrated Institutions

For exposures to unrated institutions, the 'Standardised Credit Risk Assessment' approach is to be applied. Unrated institutions will be categorised into one of three grades (A, B or C) by the reporting firm.

Based on that classification, the firm will use the risk weight from the mapping below.

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

A short term exposure is deemed to be one with the original term as six months or less.

The 40% risk weighting may be reduced to 30%, if the following apply:

- A minimum Common Equity Tier 1 capital ratio (i.e. CET1 / Total Risk Exposure Amount) of 14% AND
- Leverage ratio (Tier 1 / Leverage Exposure Amount) of at least 5%

EXPOSURE CLASS – COVERED BONDS

Externally Credit Rated Issuer

Basel 3.1 will change (relative to the CRR) the risk weights for exposures to covered bonds issued by externally credit rated institutions.

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

Issuer in Credit Quality Step 2 – risk weight to be 15% (down from 20% in CRR)

Issuer in Credit Quality Step 3 – risk weight to be 25% (up from 20% in CRR)

Unrated Issuer

Exposures to covered bonds issued by an unrated firm need to be risk weighted using the information in the following table. The reporting entity will have allocated the issuer to a category A, B or C, which should be used to get the appropriate risk weight.

Credit quality step of issuing institution (unrated institution)	A	B	C
PRA proposed risk weight for exposures to unrated covered bonds	20%	35%	100%

EXPOSURE CLASS – EQUITIES

The existing standardised approach will be replaced by a new one to be phased in over three years from 1st January 2027.

The phasing is as shown below and has been taken from Appendix 2 of policy statement 9-24.

Not Higher Risk Equity Exposures		
From	**To**	**Risk Weight**
01/01/2027	31/12/2027	160%
01/01/2028	31/12/2028	190%
01/01/2029	31/12/2029	220%
01/01/2030	Ongoing	250%

Higher Risk Equity Exposures		
From	**To**	**Risk Weight**
01/01/2027	31/12/2027	220%
01/01/2028	31/12/2028	280%
01/01/2029	31/12/2029	340%
01/01/2030	Ongoing	400%

Higher risk equity exposures are defined as:

- Those not listed on a securities exchange and / or
- A business that has existed for less than five years.

Example:
In June 2030, a business will have operated for four years. At that point, exposures to it will be risk weighted at 400%.

In June of 2031, the exposure will be classed as 'Not High Risk Equity' and weighted at 250%.

EXPOSURE CLASS – IN DEFAULT

To determine the risk weight to apply to exposures in default, it is necessary to compare the specific provision to the gross outstanding balance.

Risk Weight is dependent on

$$\frac{\textit{Specific Provision}}{\textit{Full Outstanding Balance gross of provisions}}$$

relative to 20%

If the result is at least 20%, then the exposure (except Residential Real Estate type) will be risk weighted at 100%; else at 150%.

Under CRR, the comparison was to the gross amount of the unsecured part [2] of an exposure (gross of specific provisions).

For Residential Real Estate exposures that are not materially dependent, but in default, will be risk weighted at 100%.

Requirement in Default

The 180 days past due that according to Article 178 of the Capital Requirements Regulation could be used to determine whether an exposure to central governments, local authorities and public sector entities, was in default, will no longer be an expectation. Therefore, if an exposure to the aforementioned obligors is past due a material amount by more than 180 days, it will be considered in default.

This formal need applies to firms using the standardised approach and also to those applying internal ratings based method for credit risk.

Refer to paragraph 4.185 of consultation paper 16-22 chapter 4.

[2] On a residential mortgage, the unsecured part is in the Capital Requirements Regulation, the amount over 80% 'Loan to Value'. On a commercial mortgage, the secured part is up to 50% of the market value or to 60% of the mortgage lending value.

OFF BALANCE SHEET CONVERSION FACTORS

A floor of 10% is to be introduced. Therefore the credit conversion factor of 0% in CRR is to be removed.

UK Mortgage Commitments

The conversion factor is to be 50%. Under CRR, the percentage is 20%.

Other Commitments

Other commitments that are not related to movement of goods will have a conversion factor of 40%.

Transactions such as Letters of Credit and Shipping Guarantees will have a conversion factor of 20%.

SME AND INFRASTRUCTURE SUPPORTING FACTORS

Under Basel 3.1, the supporting factors that reduce the credit risk weighted exposure amount, will not apply. A firm specific SME lending adjustment will be introduced to Pillar 2A capital.

DUE DILIGENCE

Firms will be required to assess (at least annually) the risk profile associated with a counterparty. Where there is an external credit rating and the assessment highlights increased risk, the firm must increase the credit quality step by at least one. By making that change, the risk weight will be affected.

CREDIT RISK INTERNAL RATINGS BASED (IRB) APPROACH – CHAPTER 4

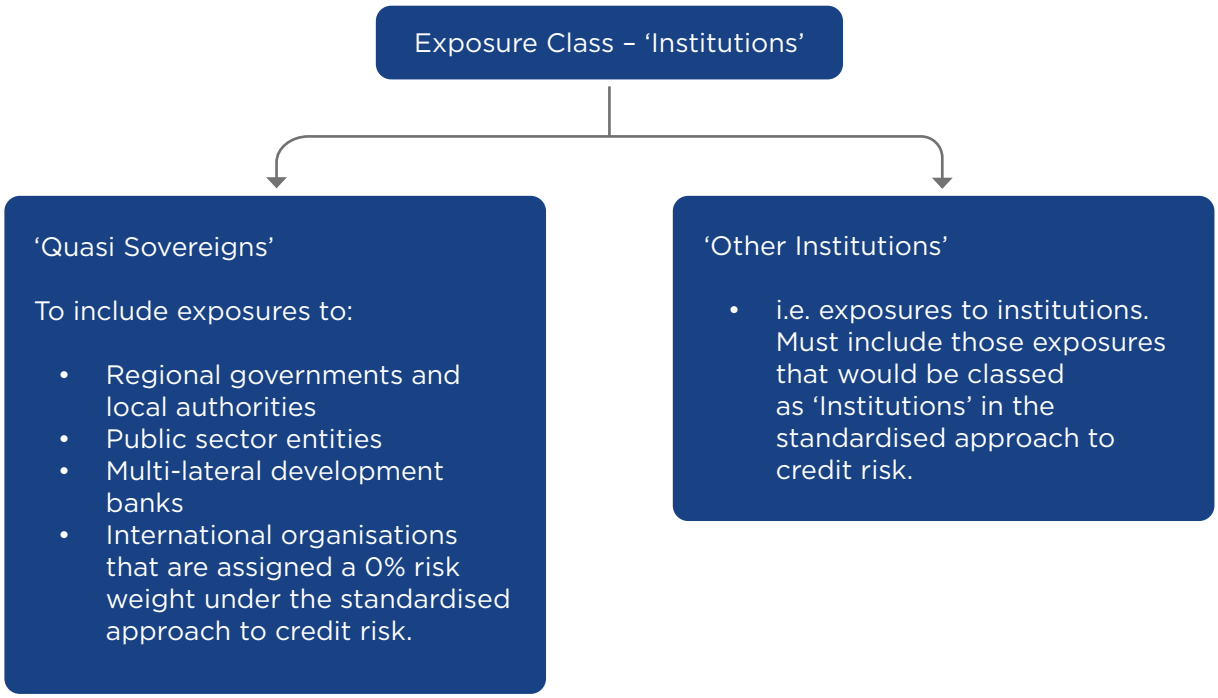
EXPOSURE CLASS – CENTRAL GOVERNMENTS AND CENTRAL BANKS

Exposures to regional / local governments, multi-lateral development banks, public sector entities, etc. must be included in the 'Quasi Sovereigns' sub-class of 'Institutions'.

EXPOSURE CLASS – INSTITUTIONS

As noted above, this class will include exposures to regional / local government and multi-lateral development banks.

Two exposure sub-classes are to be introduced within Institutions, as shown below.



Policy Statement 9-24 requires that exposures allocated to the 'Quasi Sovereigns' class, must be risk weighted under the standardised approach to credit risk.

EXPOSURE CLASS – CORPORATES

Within this category, three sub-classes (Specialised Lending; Financial Corporates and Large Corporates; General Corporates) are to be **introduced.**

EXPOSURE CLASS – RETAIL

Sub-classes are also being **added** to this group. These subs are

- Qualifying Revolving – typically unsecured and uncommitted exposures to individuals, with generally lower loss rates than other retail
- Secured by residential immovable property (not a mortgage)
- Other

Allocation of SMEs to Retail Exposures

Policy Statement 9-24 clarified that undrawn commitments must be excluded when assessing if an exposure can be classified as 'Retail'.

This policy statement stated that consideration of annual revenue of an SME can be restricted to those entities within the highest accounting consolidation of the borrower (in its jurisdiction). Only annual turnover is considered (when determining the exposure classification) for the standardised and internal ratings based approaches to credit risk.

EXPOSURE CLASS – EQUITIES

The use of internal models to calculate the credit risk exposure will not be permitted under Basel 3.1. Firms will apply the actions as shown in the following diagram.

The risk weights (phase in percentages) according to the new standardised approach are displayed in the Equities part of this document.

'Transitional Phase': (see chapter 4 para 4.82 CP 16-22 – superseded by Appendix 2 of PS 9-24 para 4.6.)

– IRB Equity Transitional Approach

i.e. apply the higher of

a. *Risk weight under the internal ratings based approach that would be applicable to the firm as at 31 December 2026*

b. *Risk weight under the new standardised method (phase-in)*

Policy Statement 9-24 advised that units or shares in collective investment undertakings will not be part of the Equities exposure class. These investments will form a separate classification.

REMOVAL OF IRB METHOD

Firms will not be allowed to use the Internal Ratings Based approach to credit risk for exposures to:

- Equities
- Central Government and Central Banks
- Quasi Sovereigns

Only the standardised approach to credit risk associated with these exposure types, will be permitted. For equities, a new standardised approach will become applicable.
Refer to the 'Exposure Class – Equities' part of this document.

SME AND INFRASTRUCTURE SUPPORTING FACTORS

Both factors will be removed from the IRB method. As is the case with the standardised approach to credit risk, firm specific SME and Infrastructure Lending Adjustments will be introduced.
Pillar 2A capital will be adjusted to offset the impact removing the supporting factors.

PORTFOLIO UK RETAIL RESIDENTIAL MORTGAGES RISK WEIGHT FLOOR

The expected 10% minimum exposure weighted average risk weight of UK retail residential mortgages, is to become a requirement (rather than an expectation).

IRB EXPECTED LOSSES AND PROVISIONS

Under CRR, where provisions exceed expected losses, the surplus (subject to a cap) can be added to Tier 2 capital. Basel 3.1 makes clear the treatment for defaulted exposures.

Scenario:

(SURPLUS) Specific Provision for defaulted exposures > expected losses for defaulted exposures

AND

(DEFICIT) Provision for non-defaulted exposures < expected losses for non-defaulted exposures

Treatment

- The surplus for defaulted exposures can be added to Tier 2 capital. The maximum that can be added is 0.6% of the credit risk weighted exposures under the Internal Ratings Based Approach. The surplus cannot be used to reduce the deficit on the non-defaulted exposures.
- The deficit for non-defaulted exposures will continue to be deducted from Common Equity Tier 1 capital.

Other Scenarios:

a. Deficit (i.e. shortfall of provision) for defaulted and non-defaulted exposures, then deduct from Common Equity Tier 1.

b. Deficit for defaulted and surplus for non-defaulted, then
   - The shortfall is deducted from Common Equity Tier 1.
   - Surplus is added to Tier 2. The maximum that can be added is 0.6% of the credit risk weighted exposures under the Internal Ratings Based Approach.

Readers may wish to refer to paragraph 4.143 of CP 16-22, for further details if required.

INTERNAL MODELLING – FULL USE REQUIREMENT

In CRR, if a firm has permission to use the Internal Ratings Based approach, then it must apply it to all credit risk exposure classes, except those:

- Deemed immaterial (class, size or risk) or
- That the 'Permanent Partial Use' of the standardised approach has been agreed with the regulator.

This 'full use requirement' will not apply under Basel 3.1.

INTERNAL MODELLING – PERMANENT USE OF SA ON 'ROLL OUT' CLASSES

That removal of 'full use requirement', will mean that the standardised approach (SA) can be used more widely by IRB firms. Such wider permanent use of the SA is to be restricted through introduction of 'Roll Out' exposure classes. Firms with permission to use IRB, will be able to apply SA (on a permanent basis) on these 'Roll Out' classes (*all exposures therein subject to the following exceptions*), only.

a. The application of SA to the 'Roll Out' classes on a permanent basis, will not be allowed if the resulting risk weighted exposure for the class would be less than 95% of the value using IRB. Exception is where modelling is not considered possible.

b. Permanent use of SA will not be *expected* to be used on 'Roll Out' classes 'Qualifying Revolving Retail Exposures' and 'Specialised Lending'. Exception is if difference to IRB is immaterial.

The 'Roll Out' classes are listed in paragraph 4.95 of PRA CP 16-22.

INTERNAL MODELLING – PERMANENT PARTIAL USE OF SA IN 'ROLL OUT' CLASSES

Basel 3.1 will (for firms with IRB permission) limit the application of SA on some exposures within the 'Roll Out' classes. 'Partial Use' will be restricted to the 'Roll Out' classes in the following circumstances:

- The firm cannot reasonably model the exposure
- The risk weighted amount calculated by SA for that exposure, is deemed to be immaterial i.e. likely to account for 5% or less than the total for the 'Roll Out' class.

Were there multiple cases of immateriality, then the partial use would be restricted to the following.

[Partial Use SA Risk Weighted Amount of 'Roll Out' Class / Total Risk Weighted Amount of 'Roll Out' Class] is to be capped at 50%

PARAMETER INPUT FLOORS

Basel 3.1 will introduce the following floors (and changes to) for use in internal models.

Probability of Default	Retail residential mortgages (UK 0.1%; non-UK 0.05%)
Loss Given Default (by exposure)	Flat and variable rates are defined on page 48 of PRA CP 16-22
Loss Given Default (by Portfolio)	The 10% and 15% floors for residential and commercial mortgages, respectively, will be removed under Basel 3.1.
Exposure at Default	Current Balance + (50% * standardised approach to credit risk conversion factor * off balance sheet exposure)
Off Balance Sheet Conversion Factors	The floor will be set at 50% of those under the standardised approach to credit risk.

DEFAULT

The 180 days past due that according to Article 178 of the Capital Requirements Regulation could be used to determine whether an exposure to central governments, local authorities and public sector entities, was in default, will no longer be an expectation. Therefore, if an exposure to the aforementioned obligors is past due a material amount by more than 180 days, it will be considered in default.

This formal need applies to firms using the standardised approach and also to those applying internal ratings based method for credit risk.

Refer to paragraph 4.185 of consultation paper 16-22 chapter 4.

OUTPUT FLOOR – CHAPTER 9

Firms that have internal model permissions, must satisfy the following for the purpose of calculating own funds and buffers.

(RWAs derived from internal models that the firm has approval to use +

RWAs where internal models cannot be used or where the standardised approach is being used)[3]

>= ([X% * RWAs were they all calculated using SA] + Output Floor Adjustment)

(SA) means Standardised Approaches

The RWAs will be the total for Pillar 1 exposures i.e.

- Credit risk (excluding counterparty credit risk)
- Counterparty credit risk
- Credit valuation adjustment – note that internal modelling is not permitted under Basel 3.1
- Securitisation exposures in the banking book[4].
- Market risk
- Operational risk – note that internal modelling is not permitted under Basel 3.1

X% is the floor and is to be introduced on an increasing scale.

[3] The standardised approach may be getting used on some credit risk 'Roll Out' classes and / or particular credit risk exposures within that category.

[4] If a firm has a synthetic securitisation, the securitised exposures remain on the firm's balance sheet. Credit derivatives are used to manage the risk associated with the on balance sheet items.

APPLICATION OF OUTPUT FLOOR

The output floor is applicable to the aggregate risk weighted exposures as stated above. These exposures are:

- All those risk weighted under a standardised approach
- All that have been risk weighted using internal models.

Policy Statement 9-24 revised the percentage Output Floor to apply during the transition period.

ENTITIES SUBJECT TO OUTPUT FLOOR

- UK Consolidated group level
- UK individual firm if not part of a group
- Ring fenced consolidation level
- Individual ring fenced entity where it is not part of a ring fenced sub-group

The Output Floor will not be applicable to UK based subsidiaries of foreign headquartered firms that have PRA permission to use Internal Model approaches. Additional data may be needed from such entities.

EXTRA CALCULATION

For the comparison against the aggregate exposure value under the standardised approaches, a firm with permission to use internal models will need two calculations of the risk weighted exposure (for those exposures to which it has permission to use internal models) amount under:

- Standardised approaches AND
- Internal models

Without calculating the risk weighted exposures under the standardised approaches, a firm would be unable to identify the floor of its Pillar 1 exposure (market, credit and operational).

OUTPUT FLOOR ADJUSTMENT

Policy Statement 9-24 will introduce an adjustment to the Output Floor calculation, so that the effects of loss provisions are considered.

The Floor will be calculated as 12.5 * (IRB T2 – IRB CET1 – GCRA + SA T2).

IRB T2	The actual amount that the firm has added to Tier 2 capital, where the provision is greater than the expected loss.
IRB CET1	The actual amount that the firm has deducted from Tier 1, where the expected loss exceeds the provision.
GCRA	The general provision that can be added back to Tier 2, up to 1.25% of the credit risk weighted exposure amount calculated under the standardised approach.
SA T2	Actual amount of general provisions that has been added back to Tier 2

Countercyclical Capital Buffer

According to note 6 of PRA consultation paper 16-22, the weighted average countercyclical capital buffer rates, will be based on the relevant exposure amounts (i.e. those irrespective of the buffer).

When the Output Floor is activated, the countercyclical capital buffer will be the weighted average percentage multiplied by the Floored RWAs.

COUNTERPARTY CREDIT RISK STANDARDISED APPROACH – CHAPTER 7

Under Basel 3.1, the alpha factor used to determine the exposure amount will be reduced from 1.4 to 1, for trades with UK Pension Funds and non-Financial corporate. Therefore, the 0.4 Alpha Add-on will fall to zero.

In all other cases, the alpha factor will remain at 1.4. Refer to paragraph 2 of Annex R of the PRA Rulebook.

The full reduction will be applicable to trades (derivatives and securities financing transactions) traded after 31st December 2026. The counterparties for such trades are restricted to UK pension funds and non-financial corporates.

For (legacy) trades entered into up to and including 31 December 2026, the capital reduction as a result of the lower alpha factor, must be maintained as Pillar 1 and then reduced over three years. That reduction will be performed through the exposure value, as described in paragraph 2 of Annex R of the rewritten PRA Rulebook. The necessary calculation of the alpha factor will be presented in the PRA Rulebook. The phasing will be revised following the delay to Basel 3.1.

From 1 January 2030 = 1.0

The adjustment will not be included in the leverage ratio exposure. Therefore, the full value will be needed there.

For trades (with UK Pension Funds and non-Financial corporate) on 1 January 2027 and after, the alpha factor will have a value of one.

CREDIT RISK MITIGATION – CHAPTER 5

Three new frameworks will be introduced to recognise credit risk mitigation and are relevant to all firms, regardless of whether they use the standardised approach or IRB for credit risk.

The three new methods for recognition of collateral in the derivation of an exposure value for risk weighting are:

- Funded collateral for exposures with counterparty credit risk
- Unfunded protection
- Funded collateral for exposures without counterparty credit risk

Funded is understood to mean collateral such as securities, commodities, receivables, etc.

UNFUNDED CREDIT PROTECTION

Standardised Approach to Credit Risk and Guarantees

The notable change effective under Basel 3.1 is where a guarantee is provided by a central government or central bank and the exposure to the guarantor is measured under the standardised approach. In that case, the preferential risk weight requires the collateral to be in the domestic currency of the guarantor.

Refer to paragraph 5.118 of CP 16-22.

Standard Approach to the direct exposure to the protection provider:

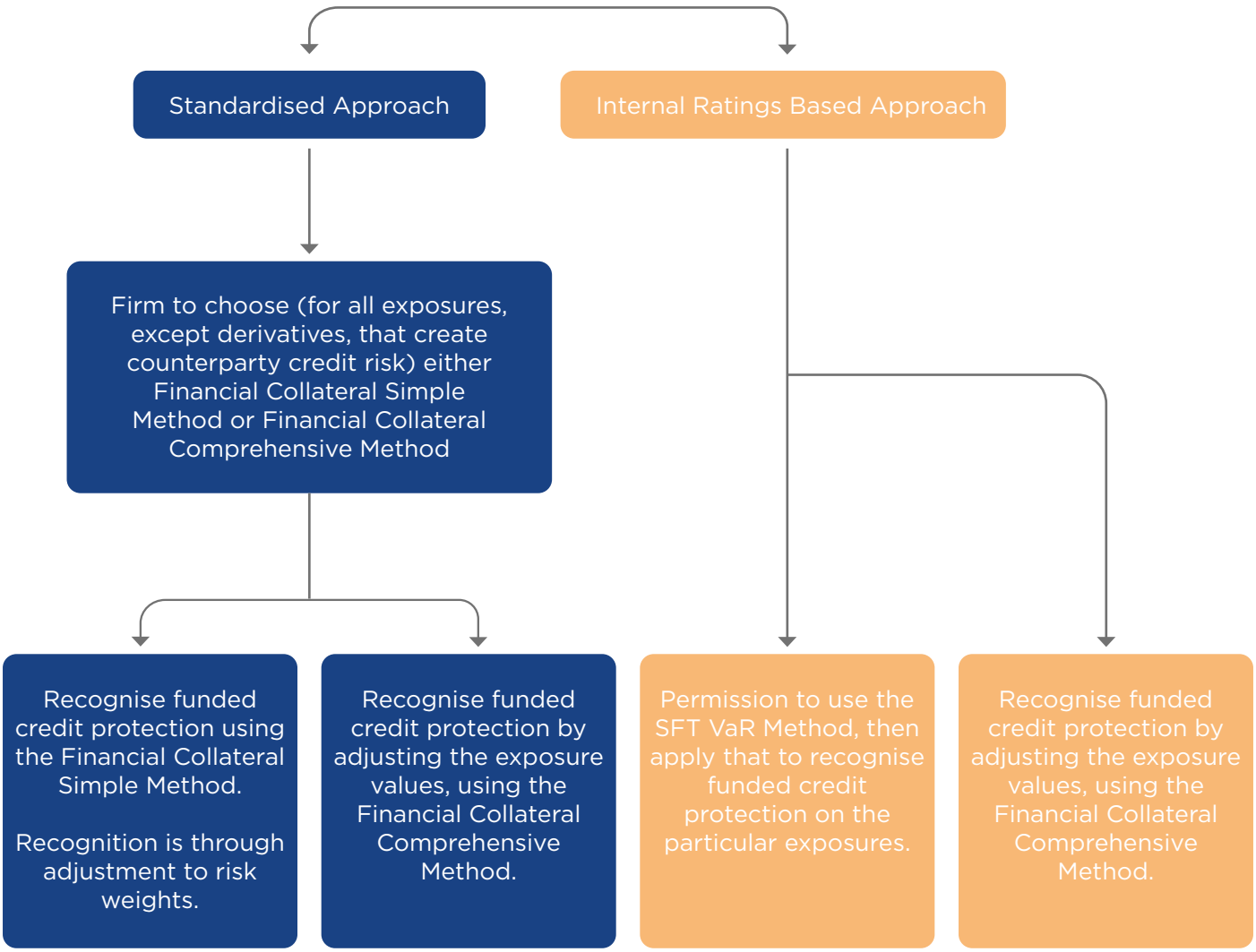
- Use the risk weight substitution (no real change relative to CRR)

Internal Models Approach to direct exposure to the protection provider:

- Use the risk weight substitution (no real change relative to CRR) OR
- Apply “parameter substitution” – e.g. on the secured part, the expected Loss Given Default percentage associated with the guarantor, is used

FUNDED CREDIT PROTECTION (FOR EXPOSURES THAT HAVE COUNTERPARTY CREDIT RISK)

For *non-derivatives*, where a firm does not have permission to use the Internal Models Method[5], then funded credit protection will be recognised as shown in the following diagram. Recognition is dependent on the credit risk approach used.



It is understood that the Financial Collateral Comprehensive Method reduces the exposure amount by the price volatility adjusted collateral value.

This document does not go into detail on SFT Var (Securities Financing Transactions Value at Risk). The view taken is that this method of recognising funded credit protection is probably not used by Whistlebrook clients.

The option for a firm to use its own estimates of volatility adjustments under Financial Collateral Comprehensive Method (where the market value is adjusted to take account of price volatility), will be withdrawn under Basel 3.1.

FUNDED CREDIT PROTECTION (FOR EXPOSURES THAT DO NOT HAVE COUNTERPARTY CREDIT RISK)

Standardised Approach (SA) to Credit Risk

For exposures subject to the standardised approach to credit risk, recognition of funded collateral will be by either the 'Financial Collateral Simple Method' or the 'Financial Collateral Comprehensive Method'. Only one method will be available for all exposures being measured under the standardised approach.

Other funded collateral such as life assurance policies and pledged third party deposits, will be recognised as currently (Article 232 CRR).

Internal Ratings Based Approach to Credit Risk

Basel 3.1 will introduce a **new method called 'Foundation Collateral Method'.**

This method will introduce changes to 'Loss Given Default' percentages (refer to table 4 on page 32 of CP 16-22). As stated above, the ability of a firm to use it own estimates of price volatility will be withdrawn.

Firms would apply the formula specified on page 29 of CP 16-22, to calculate the LGD applicable to the collateralised transaction.

It is understood that the exposure value would then be adjusted in accordance with the calculated loss given default percentage.

[5] Used for counterparty credit risk exposure calculation.

OPERATIONAL RISK – CHAPTER 8

The exposure amount will be permitted to be calculated by a new standardised approach, only. All other existing methods (including the use of internal models) available under the CRR, will be removed for Basel 3.1 firms.

There will be the following parameters associated with the calculation:

- Business Indicator
- Marginal Coefficients
- Business Indicator Component i.e. proxy for losses
- Internal Loss Multiplier (set to one, according to para 8.23 CP 16-22)

Minimum Own Funds Requirement will be calculated as

= Business Indicator Component * Internal Loss Multiplier

The various steps involved in the calculation are:

Step 1 – Get Business Indicator in each of the previous 3 financial years

Source is Annex 1 of PRA Rulebook (Operational Risk Part).

Interest, leases and dividends

a. Absolute Net Interest Income i.e. Absolute (Interest Income less Interest Expense)

b. 2.25% * Interest earning assets

c. Dividend Income

Required for each of the previous 3 completed financial years = Min (A, B) + (C)

Interest earning assets are listed in part four of template OF 16.00.

[6] Net Profit in each book is defined below.

Services

d. Max (Other Operating Income, Other Operating Expenses)

e. Max (Fee Income, Fee Expense)

Required for each of the previous 3 completed financial years = (D) + (E)

Financial

f. Absolute (Net Profit[6] or Loss in the trading book)

g. Absolute (Net Profit or Loss in the Banking Book)

Required for each of the previous completed 3 financial years = (F) + (G)

Financial includes the following (as listed in part four of template OF 16.00):

- Gains or (-) losses on derecognition of financial assets and liabilities not measured at fair value through profit or loss, net
- Gains or (-) losses on nontrading financial assets mandatorily at fair value through profit or loss, net
- Gains or (-) losses on financial assets and liabilities designated at fair value through profit or loss, net
- Gains or (-) losses from hedge accounting, net
- Exchange differences [gain or (-) loss], net

The amount to be used in the calculation is:

If 3 years' data exist

- get the total (of *Interest, Leases and Dividends; Services and Financial*) in each completed financial year
- average over the 3 years

Year	Interest, etc.	Servicing	Finance	Total
1	100	150	231	
2	200	629	745	
3	565	104	324	
Average by year	288	294	433	1,016

If 3 years' data DO NOT exist

- calculate an average based on forward estimates (see para 8.16 CP 16-22)

The result is the Business Indicator value (a proxy for operational risk loss).

Step 2 – Get Marginal Coefficients for BI Value

Based on the Business Indicator value, the marginal coefficient percentages are taken from the following table. Refer to paragraph 8.18 of CP 16-22.

BI ranges and marginal coefficients

Bucket	BI range (in £ billion)	BI marginal coefficent (ai)
1	≤ 0.88	12%
2	0.88 < BI ≤ 26	15%
3	> 26	18%

Step 3 – Calculate Business Indicator Component

Business Indicator Component = Business Indicator * Marginal Coefficients

Step 4 – Calculate Minimum Own Funds Required

Business Indicator Component * Internal Loss Multiplier

The Internal Loss Multiplier is to have a value of one, according to para 8.23 CP 16-22.

Step 5 – Operational Risk Exposure Amount

Minimum Own Funds Requirement from step 4 * 12.5

CREDIT VALUE ADJUSTMENT (CVA) FRAMEWORK – CHAPTER 7

Own funds for credit value adjustment need to be held where a firm has activities in:

a. Over the Counter Derivatives

b. Securities Financing Transactions (repos; securities and commodities borrowing / lending; margin loans) that are fair valued for accounting purposes and considered to have material CVA risk.

Standardised Methods for CVA

The existing (under the Capital Requirements Regulation) calculation of the capital requirements for credit value adjustments, is to be replaced by three standardised methods:

- Alternative Approach (AA-CVA). This method is for firms with a limited number of non-centrally cleared derivatives and is appropriate to smaller entities.
- Basic Approach (BA-CVA). This method is available to all firms. An institution can use this method and SA-CVA together, where justified. There are two branches ('reduced' and 'full') to this approach.
- Standardised Approach (SA-CVA). Approval is required to use this method. A firm can use it and BA-CVA together, where justified.

Internal Modelling for CVA

The use of internal models for CVA capital requirements will not be permitted under Basel 3.1 in the UK.

Applicability Extension

Credit Value Adjustment is to be expanded to include derivatives exposures to sovereigns, UK based pension funds and non-financial counterparties. Under CRR, such exposures are exempt from CVA (see paragraph 7.11 CP 16-22).

Firms will have a choice on how to proceed. The options are:

- Implement on 1 January 2030 – Continue to exempt those derivatives trades (with the aforementioned counterparties) that exist on 31 December 2026. Only those that still exist on 1 January 2030 will become subject to credit value adjustment. OR
- Phase-in the credit value adjustment capital requirement on those aforementioned trades. This transition requires that the exposure amount is calculated using the Standardised approach to counterparty credit risk. The own funds will be calculated using the Reduced Basic Approach and be subject to the scalar.

Reduced Basic and Scalar

i.e. Own Funds under Basel 3.1 for Credit Value Adjustment * Final Scalar

Two scalars need to be calculated for this method.

The following details have been taken from paragraph 7.1 (2) of the rewritten PRA Rulebook.

Intermediate Discount Scalar ("LEGACY EXEMPT RATIO") = Max (TW, (100% – [((OFB – Ofex) / OFB) * ((5 – t) / 5] * ((1 – TW) / (1 – 0.5))]))

TW = Transitional weighting stated in rule 7.2 in Annex K of the rewritten PRA Rulebook, within a table.

OFB = Own Funds required (as at 1 January 2027) under the Basel 3.1 rules, calculated using the *Reduced Basic Approach*. All transactions including those that were previously exempt under CRR, must be part of the number.

Ofex = Own Funds required (as at 1 January 2027), calculated using the Reduced Basic Approach method. Transactions exempt under CRR must not be included. Exposure values must be calculated using the standardised method (Article 274 of the CRR) for counterparty credit risk.

((5 – t) / 5), where t is the time since the transition period started.

i.e. t = 1 until 31 Dec 2027; 2 in the year 2028; and so on to 3 until 31 Dec 2029.

Given the transition period is only three years, the above formula may be amended to (4 – t) / 4

FINAL SCALAR = Max (LEG, [((OFB / OFBT) * LEG * 100) + (((OFBT – OFB) / OFBT) * 100)])

The 100 in bold is not included in PRA Rulebook, but without it, the formula doesn't make sense when data are included.

LEG = LEGACY EXEMPT RATIO i.e. the **intermediate discount scalar**, as explained above.

OFB = Own Funds required (as at 1 January 2027) under the Basel 3.1 rules, calculated using the Reduced Basic Approach. All transactions including those that were previously exempt under CRR, must be part of the number.

Exposure value for counterparty credit risk must be calculated using the standardised method (Article 274 of the CRR).

OFBT = Own Funds required on all trades at time T (including those previously exempt) calculated using the Reduced Basic Approach.

ALTERNATIVE APPROACH (AA-CVA)

This method can be applied where the total notional amount of non-centrally cleared derivatives is less than or equal to GBP 88 billion.

Application:
It will not be possible to use AA-CVA in combination with any of the other two methods.

Calculations:
Own Funds Required for Credit Value Adjustment (CVA) under AA-CVA (refer to para 7.32 CP 16-22)

= 100% * capital requirement for the related Counterparty Credit Risk exposures

The exposure amount associated with this capital requirement is

12.5 * Own Funds for CVA

BASIC APPROACH (BA-CVA REDUCED)

'Reduced' means that the exposure recognises that the credit spreads of counterparties are not perfectly correlated. Therefore a simple summation of the capital requirement of each counterparty, would overstate the total needed.

The following text (**taken from Annex J of the PRA Rulebook**) explains the calculation of the capital requirement for credit value adjustment exposure, using BA-CVA (Reduced).

Step 1 – Get Credit Value Adjustment Capital Requirement on a standalone basis for a counterparty (i.e. not considering correlation of risk across counterparties)

Read 'NS' as netting sets associated with the counterparty i.e. each parameter represents a total for the particular netting set.

$$SCVA_{Counterparty} = \frac{1}{a} * RW * [\sum M_{NS} * EAD_{NS} * DF_{NS}]$$

$SCVA_{Counterparty}$ – credit value adjustment capital requirement for a counterparty on a standalone basis.

Alpha Factor (a)
Under Basel 3.1, the alpha factor (a) will remain at 1.4, except where the counterparty is a UK pension fund or non-financial corporate.

In that case, the factor will be one (for trades on and after 1 January 2027). For trades with such counterparties, before that date, the factor will gradually fall to one, over the transition period.

RWC – risk weight applicable to the counterparty (see the table below)

The other parameters are defined after the following table.

Sector of counterparty	Credit quality of counterparty	
	Investment grade	High yield and Non-rated
Sovereigns including central banks and multilateral development banks	0.5%	2.0%
Local government, government-backed non-financials, education and public administration	1.0%	4.0%
Financials including government-backed financials, excluding pension funds	5.0%	12.0%
Pension funds	3.5%	8.5%
Basic materials, energy, industrials, agriculture, manufacturing, mining and quarrying	3.0%	7.0%
Consumer goods and services, transportation and storage, administrative and support service activities	3.0%	8.5%
Technology, telecommunications	2.0%	5.5%
Health care, utilities, professional and technical activities	1.5%	5.0%
Other sector	5.0%	12.0%

M_{NS} – effective maturity of a netting set i.e. counterparty

Firm using the Internal Models Method for counterparty credit risk

- Apply Article 162 para 2g of the Capital Requirements Regulation
- Only transactions with a remaining maturity above one year are considered.
- The maximum value of MNS is the longest contractual remaining maturity in the netting set.

Firm NOT using the Internal Models Method for counterparty credit risk

M_{NS} is the average notional weighted remaining maturity (see Article 162 para 2b of the Capital Requirements Regulation)

- The notional of each transaction with the particular counterparty (netting set) will be the weight
- Only transactions with a remaining maturity above one year are considered.
- The maximum value of MNS is the longest contractual remaining maturity in the netting set.

EAD_{NS} – exposure at default for a netting set i.e. counterparty. It is the exposure amount derived using one of the calculations for counterparty credit risk.

DF_{NS} – supervisory discount factor

$$\frac{1 - e^{-0.05 \cdot M_{NS}}}{0.05 \cdot M_{NS}}$$

'e' is the exponential function.

For banks using the Internal Models Method for Counterparty Credit Risk Exposure at Default, DFNS is set to one.

Result = CVA capital required for the exposure(s) to this counterparty.

Step 2 – Repeat step 1 for each counterparty

Result = CVA capital requirement by counterparty

Step 3 – Get the Aggregate CVA Capital Requirement

Take account of the correlation between different counterparties, rather than just adding up the amounts in step 2.

Total Own Funds Requirement = $DS_{(BA\text{-}CVA)} * K_{Reduced}$

$DS_{(BA\text{-}CVA)} = 0.65$

$$K_{reduced} = \sqrt{(p \cdot \sum_{C} SCVA_C)^2 + (1 - p^2) \cdot \sum SCVA_C^2}$$

Note that the first part of the above formula is termed 'Aggregation of Systemic Components' and is to be reported in template OF 25.02.

The second part is called 'Aggregation of Idiosyncratic Components'. It is also to be reported.

p – 50% and represents the correlation of credit spreads between any two counterparties

$SCVA_C$ – credit value adjustment capital requirement for a counterparty on a standalone basis (calculated from steps one and two).

Result = Reduced BA-CVA, CVA capital requirement for all counterparties, recognising that the credit spreads of counterparties are not perfectly correlated (and so the sum of CVAs would overstate the requirement)

The exposure amount associated with this capital requirement is

12.5 * Own Funds for CVA

BASIC APPROACH (BA-CVA FULL)

This method of calculating the CVA capital requirement extends the 'reduced' calculation, but takes account of the effects of hedges that reference a range of credit indices and so spread the potential loss.

Whistlebrook believes that its regulatory clients may not use hedges to reduce CVA. Therefore this document does not provide details on BA-CVA Full.

Additional information is in the PRA Rulebook, paragraph 4.5 of Annex J.

STANDARDISED APPROACH (SA-CVA)

A firm using this method to calculate the own funds for credit value adjustment, will require permission from the regulator. Other requirements to be met include:

- The presence of a dedicated function responsible for hedging CVA risk
- An ability to calculate own funds requirement for CVA risk on a daily basis
- The firm will have its own exposure models.

Given the above conditions, Whistlebrook's view is that its WIRES clients are unlikely to use this method to calculate own funds for CVA. Further details are in section 5 of the PRA Rulebook, Annex J.

MARKET RISK – CHAPTER 6

Basel 3.1 will introduce changes to the standard method for calculation of the market risk exposure value and related minimum own funds requirement. There will also be a new internal models approach (IMA). Implementation of IMA will be delayed until 1 January 2028.

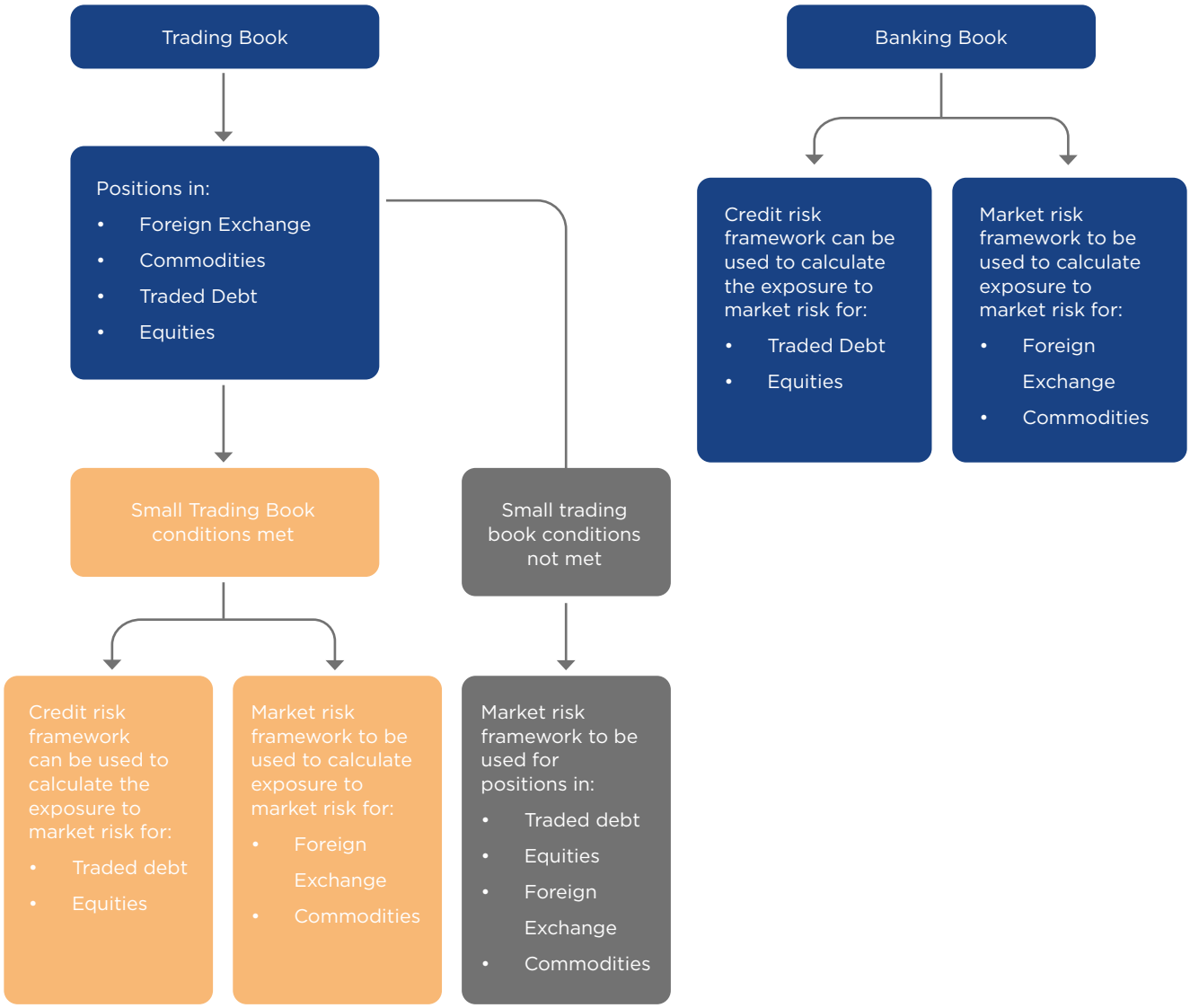
According to CRR Article 325, own funds for market risk will cover:

- All positions in the trading book (if one exists) and
- Non-trading book positions in foreign exchange and commodities
- Collective Investment Undertakings.

ALLOCATION TO BOOK

It is understood that BASEL 3.1 will continue with the following:

- Trading book positions will be subject to the market risk framework.
- Banking book items (FX and commodities excepted) will be under the requirements of the credit risk rules only.
- Foreign exchange and commodities positions (regardless of the book to which allocated) will be subject to the market risk framework.



SIMPLIFIED STANDARDISED APPROACH

The existing (under the Capital Requirements Regulation) standardised approach will be revised and become a 'Simplified Standardised Approach' (SSA).

The differences between the standardised approach in the Capital Requirements Regulation and the Simplified Standardised method in Basel 3.1, are:

a. Foreign Exchange Overall Net Position
   - Hedges to manage the effect of FX movement on capital ratios cannot be excluded from the Overall Net FX Position under Basel 3.1. That is according to Article 352 of the PRA Rulebook (paragraph 2 is blank), whilst the option (with regulator's permission) is available in the Capital Requirements Regulation (same paragraph).

b. Multipliers (shown in the formulae below) have been introduced that will scale up the own funds requirement that would have applied under the standardised approach in the CRR. See para 6.31 of CP 16-22.

This method will be used to derive the capital requirements for market risk, where either of the following are satisfied:

Condition 1 – The **small trading book derogation**[7] limits are not exceeded i.e. the firm has a small trading book.

Such a book is one where the sum of (absolute values) on and off balance sheet trading business therein is

- Below 5% of the firm's total assets AND
- Less than GBP 44million

The amounts will be the market or fair values (where former not available).

Refer to paragraph 6.21 of CP 16-22.

OR

Condition 2 – Sum of absolute values of on **balance sheet positions** (those below) **subject to market risk** (assets and liabilities) is less than both GBP 440million and 10% of the firm's total assets

The amounts will be the market or fair values ones (where former not available).

[7] With a small trading book, a firm can use a credit risk approach to measure the own funds requirement for market risk (for equities and traded debt). This option does not apply for foreign exchange and commodity positions.

Own Funds Requirement

Own Funds under the Simplified Approach will be the sum of

*Own funds for debt instruments under CRR Standardised Approach * 1.3 (CRR Articles 336, 337, 339)*

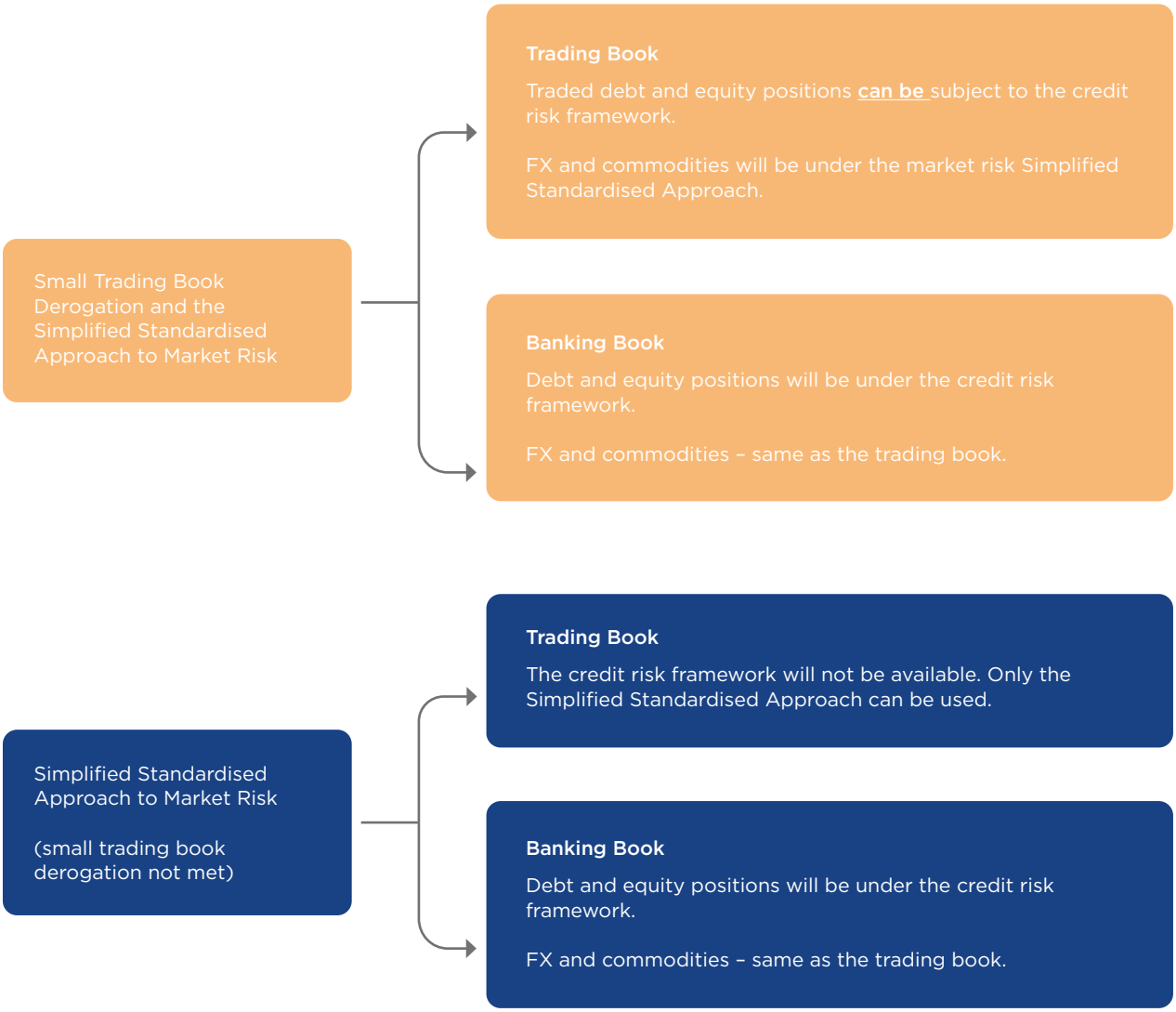
*Own funds for equity instruments under CRR Standardised Approach * 3.5 (CRR Articles 341)*

*Own funds for foreign exchange under CRR Standardised Approach * 1.2 (CRR Articles 351)*

*Own funds for commodities under CRR Standardised Approach * 1.9 (CRR Articles 359 to 361)*

Simplified Standardised Approach and Small Trading Book Derogation (SDT)

The chart below summarises the treatment under the Simplified Approach.



ADVANCED STANDARDISED APPROACH

A[8] standardised approach called 'Advanced Standardised Approach' (ASA) for calculation of capital requirements for market risk, is to be introduced for Basel 3.1 reporters that are not going to use the Simplified method.

There are three elements to the own funds requirement for market risk:

- Sensitivities based – delta, vega and curvature
- Residual risk add-on
- Default risk charge

1. Sensitivities Based

The various steps involved in this calculation are as follows.

Step 1 – Risk Class Mapping

Each position (equities, foreign exchange, commodities, traded debt, etc.) must be mapped to a risk class(es), which are specified in Article 325d (includes interest rate risk, credit spread, equities, foreign exchange, commodity) of the PRA Rulebook.

Step 2 – for the positions in a Risk Class, allocate them to a bucket

The buckets can be sector (for commodities / equities), currency, credit quality rating. A bucket will depend on the nature of the position e.g. commodity, foreign exchange, equity, maturity, issuer, etc.

Step 3 – In each bucket, identify the applicable risk factors

The risk factor is one that will vary in size and so affect the position's value.

Step 4 – (for a position in a bucket) perform a **Low Correlation Scenario**

Step 4a – By Bucket (get net sensitivity by risk factor)

For each position:

- Get the net sensitivity to a risk factor present in the bucket
- Repeat for all risk factors in the bucket

[8] This method is the same as the Alternative Standardised Approach that applied in the Capital Requirements Regulation.

Result =

For every bucket that is a member of the risk class, the net (**unweighted**) sensitivity to the risk factor(s) is known e.g.

- Bucket 1 net sensitivity to risk factor 1
- Bucket 1 net sensitivity to risk factor 2
- Bucket 1 net sensitivity to risk factor 3
- Bucket 2 net sensitivity to risk factor 1
- Bucket 2 net sensitivity to risk factor 3
- Bucket 2 net sensitivity to risk factor 4
- Bucket 3 net sensitivity to risk factor 5

And so on...

Step 4b – By Bucket (get weighted net sensitivity by risk factor)

- Go to PRA Rulebook (Article 325ae onwards) and the get risk weights by risk factor.
- Multiply each net sensitivity (to a risk factor) by the appropriate risk weight.

Result =

For every bucket that is a member of the risk class, the weighted net sensitivity to the risk factor(s) is known e.g.

- Bucket 1 weighted net sensitivity to risk factor 1
- Bucket 1 weighted net sensitivity to risk factor 2
- Bucket 1 weighted net sensitivity to risk factor 3
- Bucket 2 weighted net sensitivity to risk factor 1
- Bucket 2 weighted net sensitivity to risk factor 3
- Bucket 2 weighted net sensitivity to risk factor 4
- Bucket 3 weighted net sensitivity to risk factor 5

And so on...

Step 4c – By Bucket (get the aggregate of the weighted net sensitivities in a bucket)

Use the following regulator's specified formula in Article 325f of the PRA Rulebook. This formula takes account of (intra bucket) correlation between risk factors applicable to positions in the bucket.

$$K_b = \sqrt{\sum_k WS_k^2 + \sum_k \sum_{l \neq k} p_{kl} WS_k WS_l}$$

K_b – this is the total weighted net sensitivity of the specific bucket (i.e. the effects of all risk factors combined). The value has a floor of zero.

$Þ_{Kl}$ – this variable represents the correlation between two risk factors in the bucket.

The above formula suggests that there are just two risk factors 'k' and 'l'. All the risk factors need to be included as a pair.

Example, if there are 5 risk factors A, B, C, D and E, then following combinations must be included in the second part of the above formula.

$WS_A * WS_B$
$WS_A * WS_C$
$WS_A * WS_D$
$WS_A * WS_E$
$WS_B * WS_C$
$WS_B * WS_D$
$WS_B * WS_E$
$WS_C * WS_D$
$WS_C * WS_E$
$WS_D * WS_E$

$$\sum_k WS_k^2$$

The above is the sum of the squared weighted net sensitivities

RESULT = Total weighted net sensitivity across all risk factors in the specific bucket.

Repeat the above calculation for every bucket in the risk class

RESULT = For each bucket within the risk class, there will be a weighted net sensitivity.

Step 4d – Aggregate the weighted net sensitivities across all the buckets applicable to a risk class

In this summation, the correlation between sensitivities in the different buckets (inter bucket correlation) is taken into account. The formula is in the PRA Rulebook, Article 325f paragraph 8.

$$\sqrt{\sum_b K_b^2 + \sum_b \sum_{c \neq b} \gamma_{bc} S_b S_c}$$

$$\sum_b K_b^2$$

γ_{bc} = correlation between the buckets. The value depends on the correlation scenario, Low, Medium or High. Refer to Articles 325h and from 325ag to 325aw of the PRA rulebook.

This part of the formula is the summation of the squared weighted net sensitivity in each bucket within the risk class, calculated in step 4c, above.

The above formula suggests that there are only two buckets (b and c). Where there are more than two, every pair must be considered in the same way as in the earlier example, step 4c, above.

S_b = weighted net sensitivity in bucket 'b'. Again, if there are more than two buckets, then this variable will not be restricted to just one of them.

Scenario – in the above calculation prior to applying the square root, is a negative value:

The formula for S_b (bucket specific) is amended to

$$S_b = \max[\min(\sum_k WS_k, K_b), -K_b]$$

This formula does the following:

WS_k is the weighted net sensitivity by risk factor 'k' in the bucket

K_b is the total net weighted sensitivity in the bucket (calculated in step 4c).

Denote (A) as being the result of the formula adding up all the weighted net sensitivities per risk factor 'k' in the bucket.

$$\sum_k WS_k$$

Take the minimum of (A) and the total weighted net sensitivity for the bucket (calculated in step 4c)

Deduct the total weighted net sensitivity for the bucket (calculated in step 4c).

RESULT under this scenario is the total weighted net sensitivity for this bucket and to be used as the variable S_b in the above formula. A repeat for all the buckets would be required.

Step 5 – Capital Requirement for this Risk Class

The result of calculation in step 4d is weighted net sensitivity for Risk Class 'x' in the low correlation scenario.

Step 6 – Repeat Step 4d for Medium and High Correlations

The different correlations are represented through the variable γ_{bc} in the above formula. Refer to Articles from 325ag to 325aw in the PRA rulebook

RESULT = Delta weighted net sensitivity under the low, medium and high correlations for the particular risk class.

Own Funds Requirement for the particular risk class is explained in Own Funds Requirements – Market Risk.

2. Residual Risk Add-on

Some firms may require a capital add-on for certain positions subject to market risk.

The required calculation will typically be

Capital Requirement Add-on = Gross notional position * 1%

Source – paragraph 6.43 CP 16-22.

Refer to PRA Rulebook Article 325U.

3. Default Risk Charge

The capital requirement refers to the risk of outright default associated with:

- Holdings of debt and equity positions
- Debt and equity instruments that are the underlying in a derivative.

The only change being introduced by the PRA in implementing BASEL 3.1 is to the calculation of the 'Gross Jump to Default' value. The calculation is said to be slightly different to that actually specified in BASEL 3.1.

The 'Gross Jump to Default' (i.e. the loss or gain that could be incurred were the issuer of the instrument to default) for a long or short position is

= Current market value less the value were there an instant default + 'Recovery'

'Recovery' is defined as Notional * (1 – regulator specified loss given default)

Further details on Default Risk Charge on non-securitisations are in the Capital Requirements Regulation (Articles 325w to 325y).

COLLECTIVE INVESTMENT UNDERTAKINGS

External Party Approach

'Basel 3.1 will introduce an exposure measurement approach, where the exposure is treated as a single equity investment and the risk weight used is derived by an external party.'

Under this method:

- A risk weight for the CIU would need to be available and calculated by an external party
- That party must have knowledge of the exact investments held by the CIU and also have its risk weight calculation audited by an independent organisation. Refer to paragraph 6.51 of CP 16-22.

OWN FUNDS REQUIREMENTS – MARKET RISK

Under the Advanced Standardised Approach, the own Funds Requirements for Market Risk are calculated as follows.

Low Correlation = Sum of Delta, Vega, Curvature sensitivities under this scenario

Medium Correlation = Sum of Delta, Vega, Curvature sensitivities under this scenario

High Correlation = Sum of Delta, Vega, Curvature sensitivities under this scenario

Own Funds = Max (Low, Medium, High correlation sensitivity scenarios) + Residual Risk Add-on + Default Risk Capital

Total Risk Exposure Amount = 12.5 * Own Funds

INTERNAL MODELLING FOR RISK EXPOSURE

Basel 3.1 will not permit the use of internal models for exposure calculations in the following areas:

- Credit risk – equities; central government and central banks. For equities, an IRB Equity Transitional Approach can be used.
- Operational risk
- Credit Value Adjustment

For equities, there is the following choice.

'Transitional Phase': (see chapter 4 para 4.82 CP 16-22 – superseded by Appendix 2 of PS 9-24 para 4.6).

– IRB Equity Transitional Approach

i.e. apply the higher of

a. Risk weight under the internal ratings based approach that would be applicable to the firm as at 31 December 2026
b. Risk weight under the new standardised method (phase-in)

REGULATORY REPORTING UNDER BASEL 3.1 – CHAPTER 12

For Basel 3.1 reporters, new requirements will be introduced for COREP and Forecast Capital+. Some forms used in the existing Capital Requirements Regulation will be amended, whilst new ones will be added, particularly for Market Risk.

Taxonomy

A new Banking taxonomy will be introduced for collection of data from the Basel 3.1 reporters. Validation rules will also be provided.

Market Risk (under the Simplified Standardised Approach)

Reporting will continue to use the existing COREP templates C 18 to C 23.

Operational Risk

Policy Statement 9-24 has advised that reporting the Internal Loss Multiplier and Historical Losses, will be required annually. All other reporting for Operational Risk will have a quarterly frequency

Volume of Changes

COREP – (changes 12, deletions 8 and new 19 of which 14 are for market risk*)

Forecast Capital+ – amendments to PRA102 and PRA103

*10 of that 14 are specifically relevant to firms reporting under the Advanced Standardised Approach.

DISCLOSURES – CHAPTER 11

Clients that will be subject to Basel 3.1, will use some existing disclosure templates that will be amended and others that will remain unchanged.

There will also be new disclosure templates in certain areas including market and operational risk.

Disclosure Template Change	No. of Forms
Amendment	13
Not Changing	11
New	17

Whistlebrook: Basel 3.1 PRA Policy Statements 17-23 and 9-24