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Basel 3.1 survey report

Implementation of Basel 3.1 in the UK

February 2024

Contents

Executive summary

The Basel III capital framework was developed by the Basel Committee on Banking Supervision ('BCBS') in response to the global financial crisis of 2007-2008. In the UK, the Prudential Regulation Authority ('PRA') published a consultation paper ('CP16/22') in November 2022 on the implementation of the reforms (referred to as 'Basel 3.1'), which are due to be implemented on 1 July 2025.

With the deadline fast approaching, Deloitte discussed the proposed changes with its clients and set up a survey to identify the key challenges of implementing Basel 3.1 and the most significant impacts that firms are facing. Firms responded by the end of September 2023, prior to the publication of the first 'near-final' policy statement ('PS17/23') which covered market risk, credit valuation adjustment and operational risk.

Key findings

- At the time of the survey (September 2023), many firms had already established Basel 3.1 programmes and had made good progress in understanding the impacts of the proposed changes. However, even those with relatively mature Basel 3.1 programmes still had a lot to do.
- Firms' expectations of total risk weighted assets ('RWA') impact varied, but the most commonly expected impact was a 5% to 10% increase.
- Smaller firms and building societies considered there to be greater commercial and strategic implications as a result of Basel 3.1 implementation than large multinational firms and their subsidiaries.
- Respondents recognised the need for action in making regulatory reporting changes. Other areas commonly identified as requiring changes were capital planning, RWA optimisation, enhanced data management and quality.
- Many firms were experiencing data challenges in relation to the standardised approach ('SA') for credit risk. These included capturing the latest compliant valuation of mortgaged property, undertaking due diligence on external ratings and monitoring data for proposed risk weight concessions on (i) mortgages – where repayment is not materially dependent on cash flows generated by the property, and (ii) unsecured retail exposures.
- Most firms were expecting a moderate impact from the output floor ('OF') on their mix of products and medium to long-term business strategy, and a low impact on capital allocation, product and transaction pricing, and limits.

Conclusion and outlook

- Firms are advised to make progress on their programmes based on CP16/22 and PS17/23, while building in flexibility to be able to adjust for changes in the second set of 'near-final' rules. This includes work on data sourcing and systems building which were generally less advanced than expected as of September 2023.
- Firms that can demonstrate they have fully compliant RWA calculations through a parallel run ahead of the revised implementation date should be well equipped for conversations with their supervisors and other stakeholders. Notwithstanding this, firms should ensure that they are capturing all aspects of the credit lifecycle (e.g., risk appetite, risk limits and decisioning and pricing) in their Basel 3.1 programme and not just regulatory reporting,
- Given the cost of running regulatory models and Basel 3.1's intent to restrict the RWA benefits that internal models ('IMs') can provide, a review of the model landscape is advisable. Additionally, IM firms should consider now needing to run RWA calculations for SA alongside IM, which will require building calculation infrastructure, upskilling and additional resource to manage oversight,
- Firms should consider strategy for managing regulatory divergence and potential mitigants to minimise the challenges from their international presence. This could include bringing forward planned implementation dates to align to regions where compliance is sooner than the UK's 1 July 2025 to avoid the risk of multiple change cycles.

Deloitte can support banks with further analysis of Basel 3.1 impacts, as well as interpreting the proposed regulation and implementing the required changes. Please get in touch with our experts if this would be of interest and we can discuss how we can most appropriately tailor our support to your requirements. Deloitte would like to thank all firms which participated in the survey.

Background

a) Background to Basel 3.1

The Basel III capital framework was developed by the BCBS in response to the global financial crisis of 2007-2008, with the aim of strengthening the regulation, supervision and risk management of firms. The initial set of rules, known as 'Basel III' was adopted by the BCBS in 2010 with enhancements made in 2011. The framework was finalised with 'Basel III: Finalising post-crisis reforms' ('The Final Basel III Reforms') in December 2017 and a revised version of 'Minimum capital requirements for market risk' in January 2019.

The Final Basel III Reforms represent a fundamental change in the way firms calculate RWA. The revisions to the Basel framework are expected to have widespread implications for banks, affecting business strategy, data and systems architecture, as well as their operational processes and controls.

Since publication, different jurisdictions have been working to implement the reforms into national law. In the UK, the PRA published a consultation paper CP16/22 in November 2022 on the implementation of the reforms, which the PRA refers to as 'Basel 3.1'.[1] The first of two 'near-final' policy statements was released in December 2023 covering market risk, credit valuation adjustment and operational risk.[2] The PRA expects to publish its second 'near-final' policy statement in Q2 2024 which will cover credit risk, the OF, reporting and disclosure.[3]

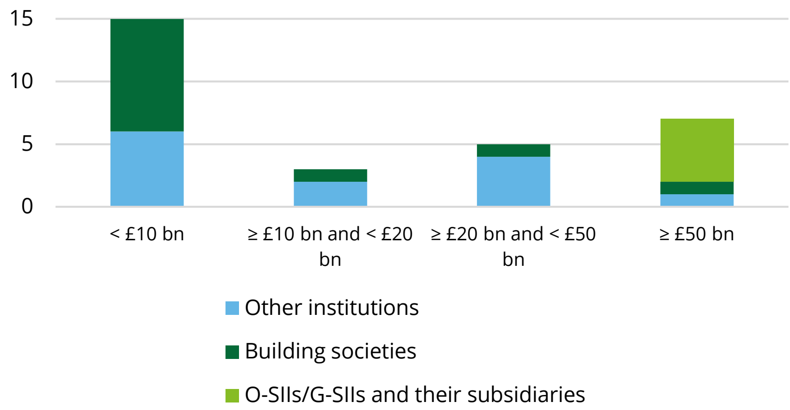
The focus of this report is UK firms' preparation for Basel 3.1. This consists of the proposed changes in CP16/22, but not the first 'near-final' policy statement since it was not published at the time the survey was active.

b) Basel 3.1 survey set-up

The survey was launched in August 2023 and firms responded by the end of September 2023. Financial institutions operating in the UK, including: Global Systemically Important Institutions ('G-SIIs') and Other Systemically Important Institutions ('O-SIIs') and their subsidiaries, building societies, and other PRA-regulated institutions were invited to participate.

In total, 30 firms responded to the survey, of which: five were O-SIIs or G-SIIs and their subsidiaries, 12 were building societies and 13 were other PRA-regulated institutions. The sample represents institutions of differing size, business model and use of IM approaches. This is represented in Figures 1-3.[4]

Figure 1. Respondents by total assets



[1] CP16/22: Implementation of the Basel 3.1 standards
[2] PS17/23 – Implementation of the Basel 3.1 standards near-final part 1
[3] The PRA publishes the first of two policy statements for the implementation of the Basel 3.1 standards | Bank of England
[4] IRB firms must apply retail IRB for retail exposures, but for non-retail portfolios firms may apply advanced IRB, foundation IRB or slotting (for specialised lending only), depending on supervisory approval. As such, one firm can have multiple permissions.

Figure 2. Respondents by internal model permissions

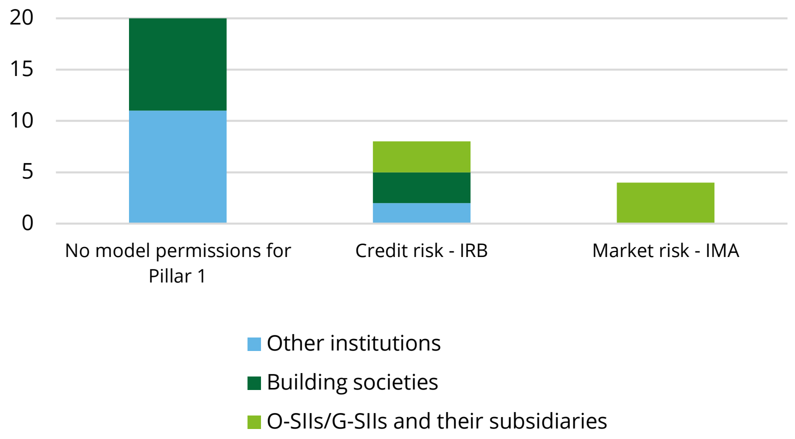
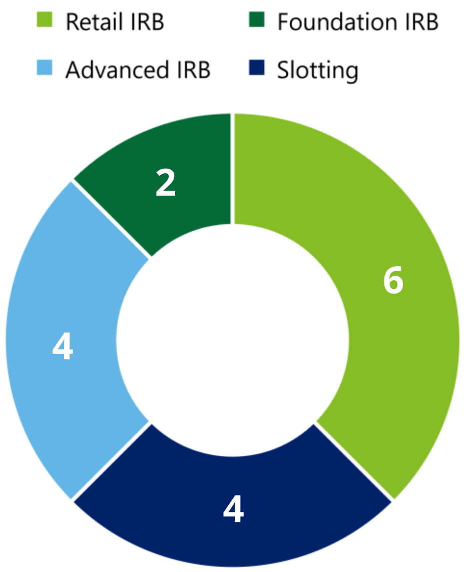


Figure 3. Respondents by IRB permission



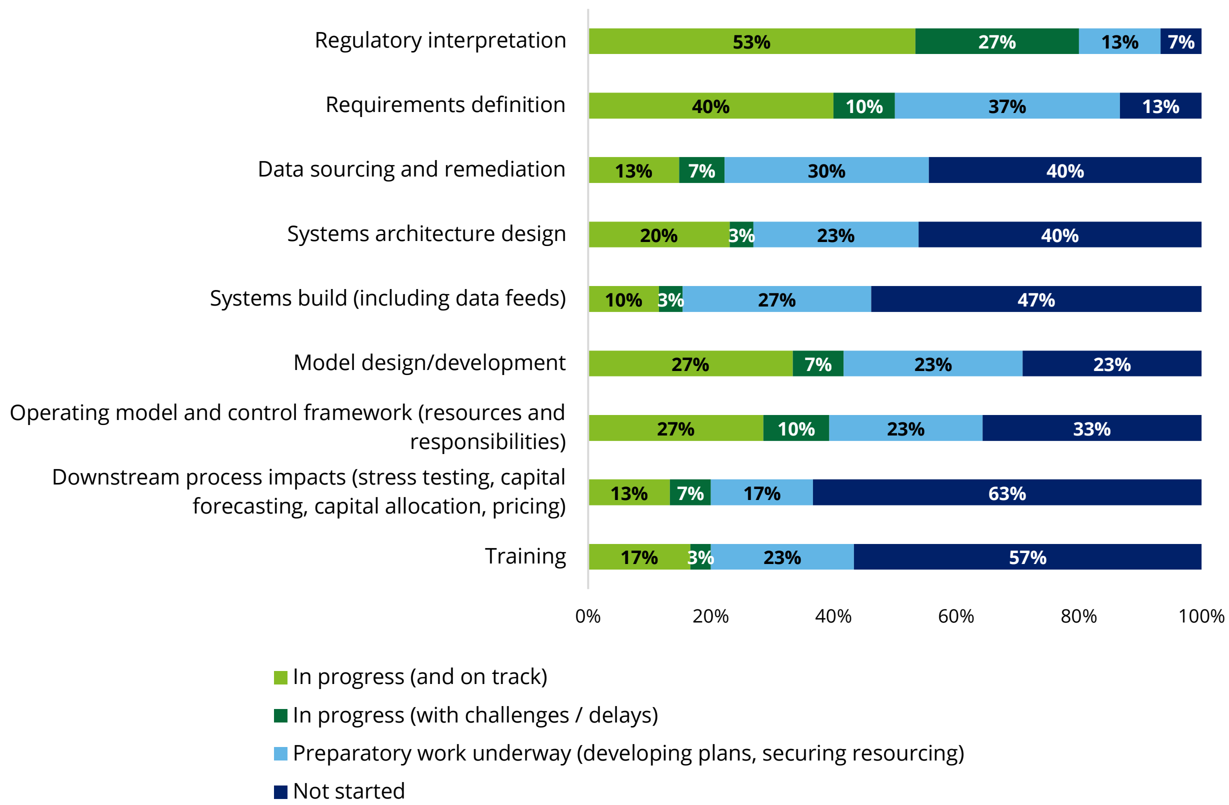
Overview of Basel 3.1 implementation programmes

a) Basel 3.1 implementation activities

Table 1. Have you already started activities to support the implementation of the UK's proposed Basel 3.1 framework?		Respondents
Yes	We have a programme / project established with an agreed budget, sponsorship and resourcing in place	27%
	We have a programme / project underway and are confirming agreed budget, sponsorship and resourcing	17%
No	Activity is planned for later in 2023	33%
	We will be active in 2024 at the earliest	23%

Table 1 provides details of the level of maturity of respondents' Basel 3.1 programmes at the time of the survey. Even for those with relatively mature programmes, there was still a considerable volume of activity for firms to complete ahead of implementation. Many made good progress with the regulatory interpretation and impact assessment streams of their Basel 3.1 programmes. In addition, larger multinational banks made good progress with requirements definition and systems architecture design. However, 40% and 47% of respondents had not started their data sourcing and systems building activities, respectively. Other areas which many firms did not start are downstream process impacts (63%) and training (57%). Figure 4 provides further details of the progress firms made on Basel 3.1 activities as of September 2023.

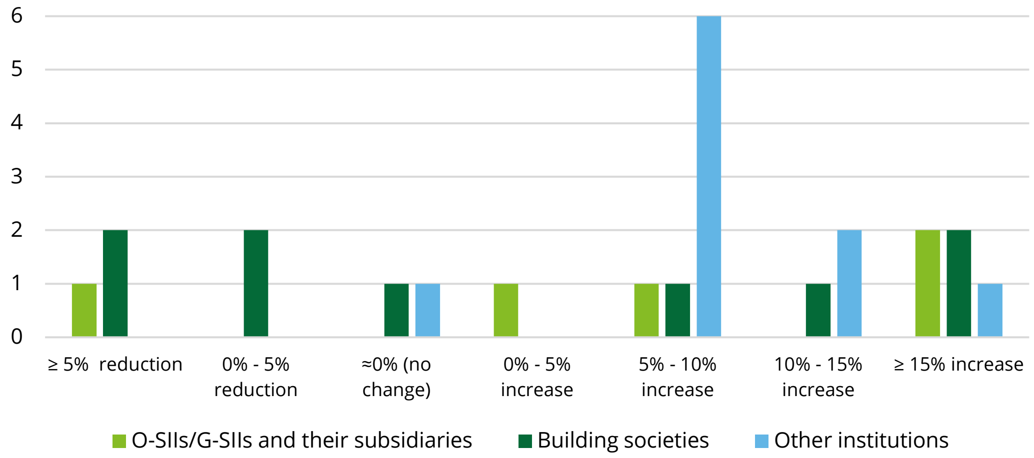
Figure 4. Progress of Basel 3.1 related activities as of September 2023



b) RWA impact and challenges related to Basel 3.1 implementation

Firms were asked what overall RWA impact they anticipated as a result of the full implementation of Basel 3.1. The results are shown in Figures 5 and 6.

Figure 5. What overall RWA impact does your institution anticipate as a result of Basel 3.1 implementation?

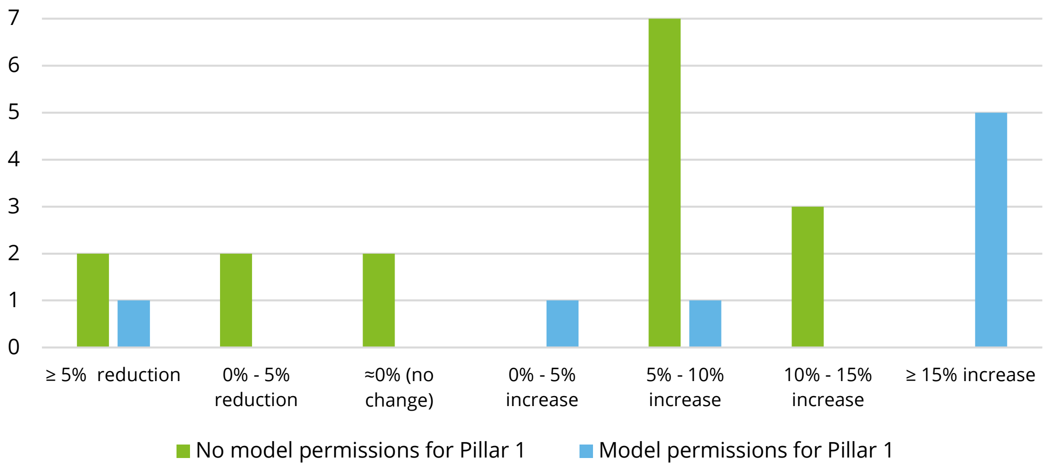


RWA impact will vary depending on individual firms and their risk profiles. However, the survey results indicate that firms were generally expecting an increase in total RWAs and that the most popular range was a 5% – 10% increase.

Building societies gave a more mixed response, with some anticipating a reduction in RWA and some an increase, which is driven by whether they have internal ratings-based approach ('IRB') permissions. IRB building societies were expecting an increase in RWA, whereas SA building societies anticipated varying results as the more risk-sensitive SA is applied (particularly for residential mortgage portfolios which make up a significant proportion of their total exposure).

Firms which apply modelled approaches were generally expecting an increase in RWA with the most commonly expected range being a ≥ 15% increase. This is likely a result of the Basel 3.1 standards' intent to restrict the RWA benefits that IMs can provide, for example through the IRB parameter floors and the OF.

Figure 6. What overall RWA impact does your institution anticipate as a result of Basel 3.1 implementation? (by model permission)



Firms were asked what strategic or commercial impacts they expect from the implementation of the Basel 3.1 framework. The results are shown in Figure 8 and indicate that smaller firms and building societies considered there to be greater commercial and strategic implications compared to the larger firms and their subsidiaries.

Respondents cited changes to small and medium-sized enterprises ('SME') lending as a result of the support factor removal as being an area for business model realignment. They also emphasised that the changes to mortgage lending in the following segments could force portfolio realignment:

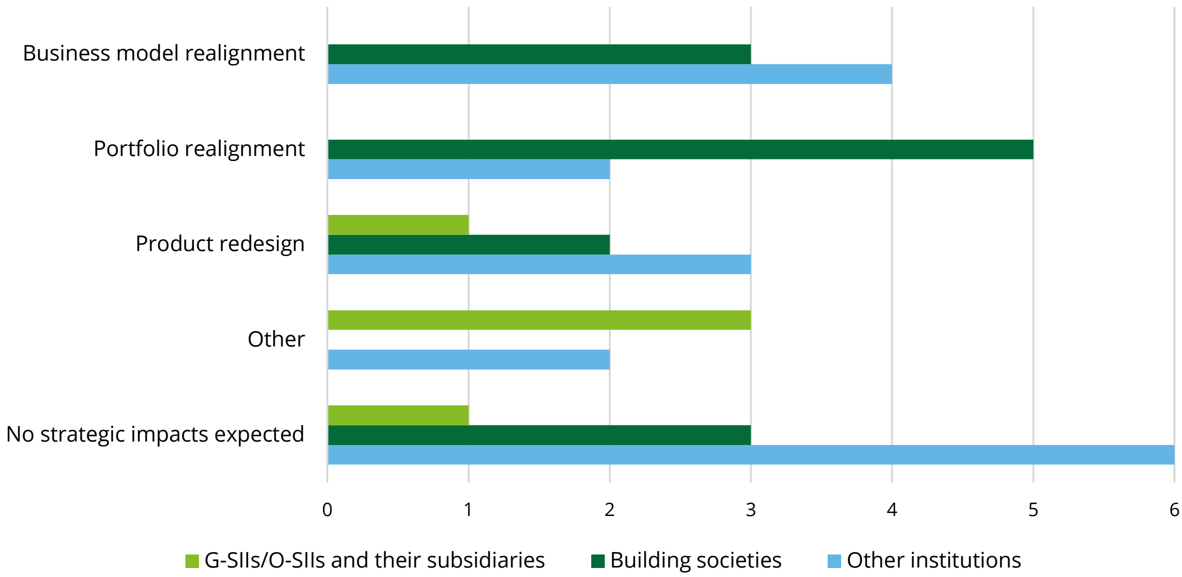
(i) high loan-to-value;

(ii) buy-to-let;

(iii) holiday lets; and

(iv) self-build.

Figure 8. What strategic or commercial impacts does your institution expect from the implementation of the UK's Basel 3.1 framework?



One firm expected impact on product redesign due to possible changes to pricing and geographical offerings caused by regulatory divergences. Additionally, one firm expected an increased difficulty in managing communications with head office due to regulatory divergences. This firm also cited potential operational and resource impacts from the implementation of Basel 3.1.

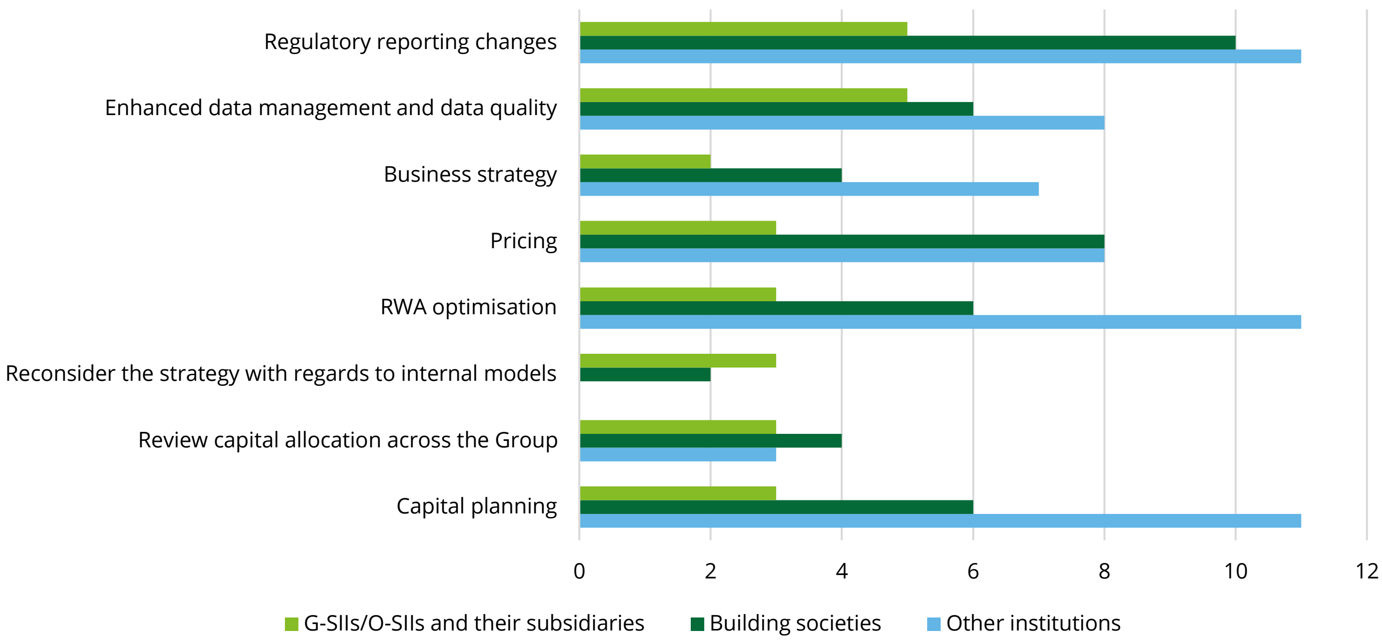
Firms were also asked how far they had progressed with implementation activities for Basel 3.1 – see Figure 9. Unsurprisingly, respondents recognised the need for action in making regulatory reporting changes. Other areas commonly identified as requiring changes were capital planning, RWA optimisation, enhanced data management and quality. The latter recognises that:

(i) SA firms will need to ensure that they have all the additional required data fields to run the more risk-sensitive standardised calculations; and

(ii) IRB firms, where necessary, will need to both source the historical data required and set up processes for go-forward collection.

The other area which respondents indicated would require action is governance. The complexity of the revised rules is likely to produce challenges for firms in relation to oversight of changes to controls, business processes and IT infrastructure. For IM firms, this now includes needing to run RWA calculations for SA alongside IM, which will require upskilling and additional resource to manage oversight.

Figure 9. In response to the new requirements, in which areas does your institution see a need for action?

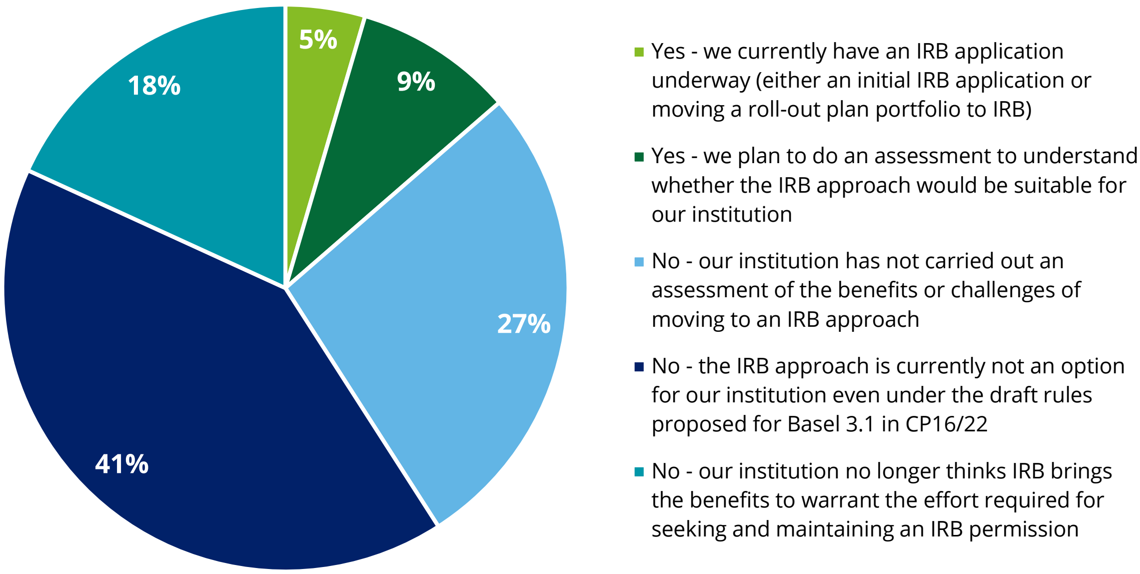


Credit risk

a) Results of the survey – RWA impact analysis

Firms were asked whether the proposed rules in CP16/22 change their view on the approach they wish to apply for credit risk. The results are shown in Figure 10. As a result of the increased risk sensitivity in the SA and new constraints on IRB, 68% (four) of SA respondents which had undertaken an IRB impact assessment determined that the benefits of IRB no longer warrant the effort required for seeking and maintaining IRB permission.

Figure 10. SA Firms Considering Moving to IRB



The PRA has proposed to withdraw its existing expectation regarding the maximum proportion of a firm's RWAs that may remain on the SA when an IRB permission has been granted. However, the PRA has introduced a number of safeguards to avoid 'cherry-picking' opportunities, where firms are able to optimise RWAs through their choice of which exposures should remain on the SA. Notwithstanding this, some firms indicated that they plan to apply for a reversion to the SA for retail unsecured and large corporate portfolios.

Respondents which apply the SA were asked to indicate their anticipated change in total credit risk RWA for different exposure classes and sub-classes. The anticipated impacts of the proposed rule changes varied across respondents.

Residential real estate

For residential real estate exposures, responses were mixed as a result of the more risk-sensitive SA producing varying results depending on the loans-to-value within firms' residential mortgages books.

Commercial real estate

The PRA has proposed to retain its existing 100% risk weight floor for commercial real estate lending. In line with this, six firms expected minimal change. However, two firms expected an increase of between 2.5% and 7.5% and five firms expected an increase of between 7.5% to 15%. This would imply that the latter anticipated a significant amount of their portfolios going into the new materially dependent on cashflows bucket which would attract a more penal 110% risk weight.

SME

80% of firms expected RWAs for their retail SME portfolio to increase. Non-retail qualifying ('corporate') SME portfolios see an increase in some cases, but this is less pronounced than for retail SMEs. The increase is driven by the removal of the SME support factor, though, this is compensated for by the introduction of an 85% risk weight for corporate SMEs.[5] In the absence of this compensating treatment, unrated corporate SMEs would be assigned a risk weight of 100%.

Corporates

The majority of respondents expected minimal change for unrated corporate exposures. This may be an indication that they do not intend to apply the new 'risk-sensitive' approach and will continue applying a 100% risk weight as in the UK Capital Requirements Regulation, referred to in CP16/22 as the 'risk-neutral' approach. Note that this assessment does not include IRB firms.

The majority of firms did not carry out an RWA impact assessment for the new specialised lending asset class. For those that did, an increase in RWAs (< 15%) is expected for project finance exposures. This is due to:

(i) the removal of the infrastructure support factor, where the mitigating high quality discount (80%) does not entirely cover all exposures; and

(ii) the introduction of the more penal 135% risk weight for project finance exposures in the pre-operational phase.

IRB

At the time the survey was conducted, more than half of the respondents had carried out RWA impact assessments for their IRB models. However, the RWA impact for the parameter floors (probability of default, loss given default, exposure at default) was expected to be low post-IRB repair model implementation. An exception to this may be for low-default portfolios as a result of probability of default not being permitted to be less than 0.05%.

One IRB firm reported that it was anticipating a significant increase in RWA (> 15%) for relevant portfolios due to the removal of the SME and infrastructure support factors.

None of the respondents expected changes from the withdrawal of the advanced IRB and foundation IRB approaches for income producing real estate (referred to as 'IPRE').

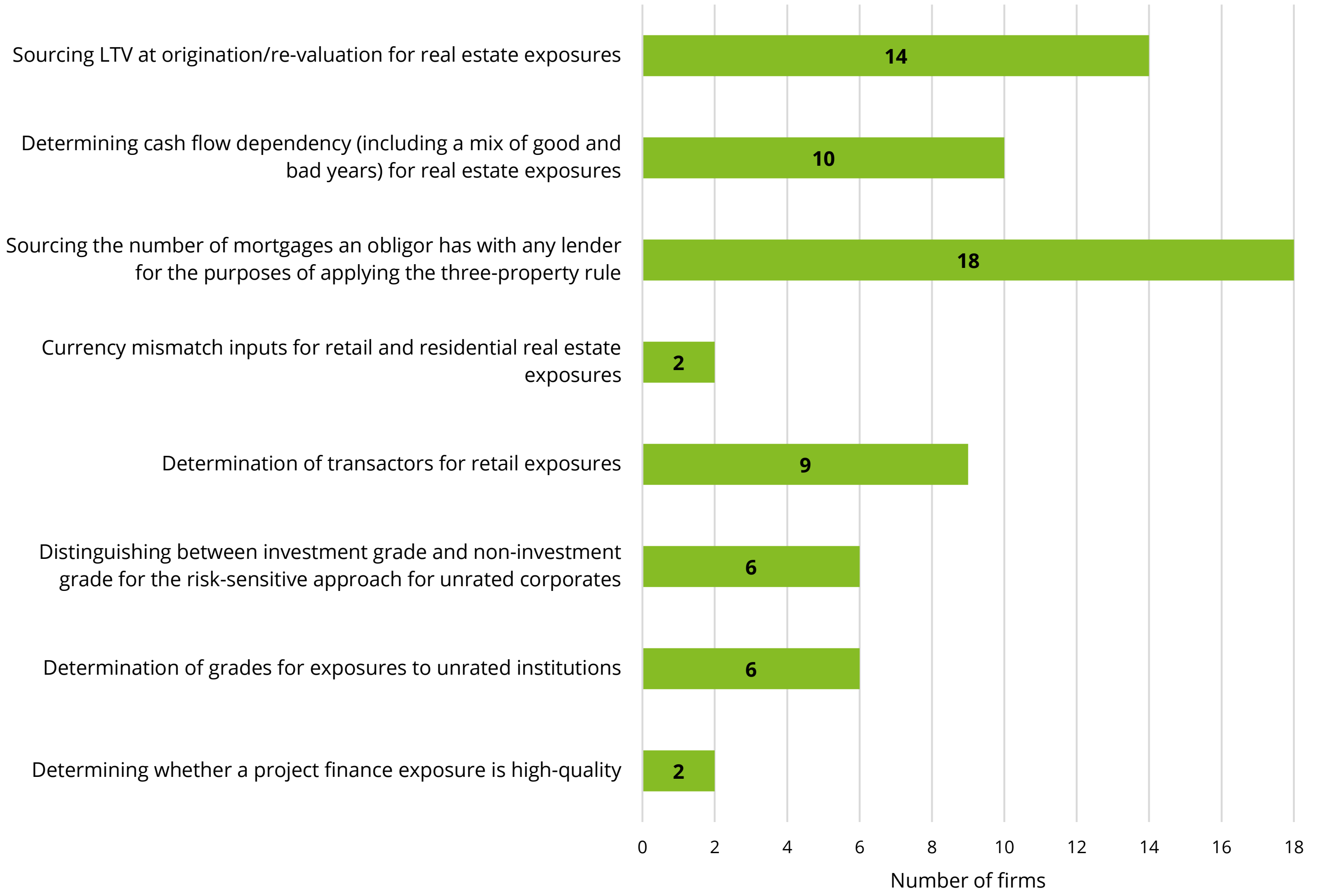
Eight respondents to the survey indicated their RWA impact assessment had considered credit risk mitigation changes and 16 respondents did not, of which seven said they would be doing so at some future date.

c) Results of the survey – SA implementation challenges

Respondents were asked to indicate where they were experiencing data challenges (if any) within the new SA framework. There was a number of data challenges suggested for selection, with firms being able to indicate any other challenges not listed. Figure 11 shows the results.

[5] The SME SF is 76.19% for the first £2.2mn of exposure and 85% for the remaining portion above £2.2mn, therefore larger SME exposures (>£2.2mn) receive a smaller increase in risk weight than smaller exposures (<£2.2mn) as a result of removing the SME SF and introducing an 85% risk weight for corporate SMEs.

Figure 11. Standardised approach: data challenges



A key challenge for firms is the new requirements for the real estate asset class. The following changes were called out as the greatest challenges:

(i) capturing the latest compliant valid valuation of the property;

(ii) monitoring data for a proposed risk weight concession for mortgages where repayment is not materially dependent on cash flows generated by the property;

(iii) undertaking due diligence on external ratings of corporates and institutions; and

(iv) monitoring data for a proposed risk weight concession on unsecured retail exposures.

Firms were also asked which of the proposed components within the SA framework were posing the greatest challenges in implementation. Several challenges were suggested, with firms able to indicate any other challenges not listed. The results are shown in Figure 12.

Figure 12. Standardised approach: assessment of implementation challenges

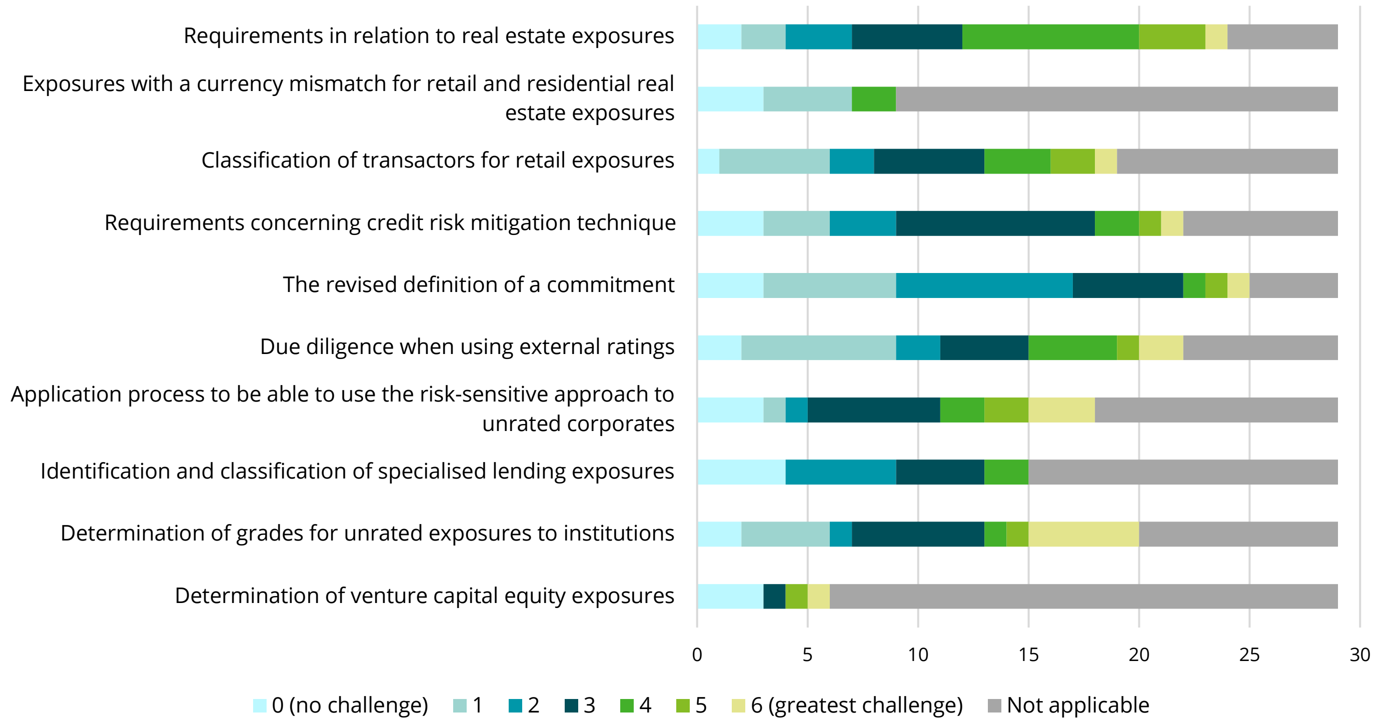


Table 2 provides details of respondents' effort expectation for Basel 3.1 implementation of the new SA rules with regards to data. The majority of firms were expecting between three and nine months to be required for implementation which aligns with the PRA's plan of giving firms a year for implementation from publication of the 'near-final' rules.

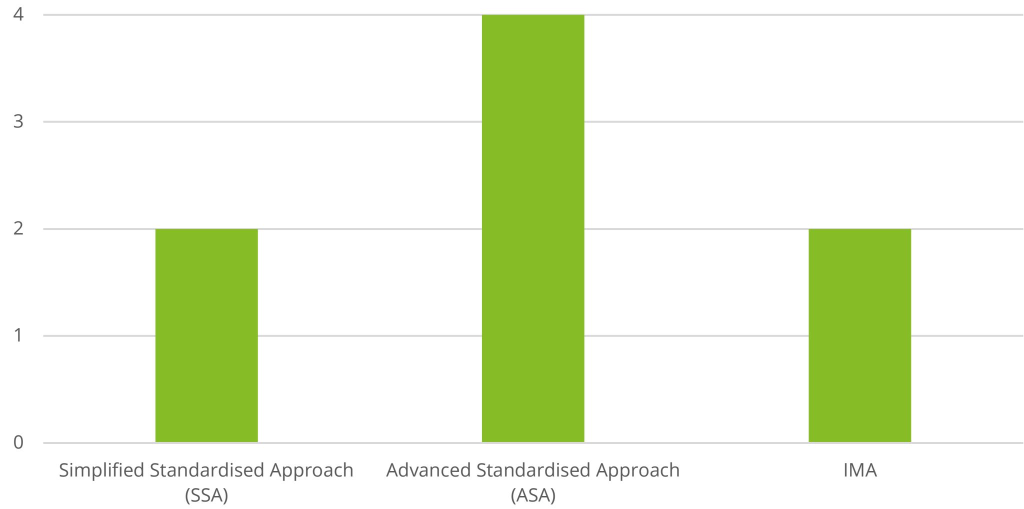
Table 2. Estimated effort for the implementation of the SA rules including enhancing data availability and quality	Respondents
Low (1-3 months)	3%
Low to medium (3-6 months)	40%
Medium to high (6-9 months)	37%
High (more than 9 months)	20%

Market risk

As of September 2023, nine respondents were required to calculate market risk capital requirements under Basel 3.1. However, we have only included firms with assets ≥ £20 bn in this section to avoid introducing bias into results from sectors with a small sample size (of which there were two).

The market risk capital calculation planned approaches for respondents to the survey are summarised in Figure 13.

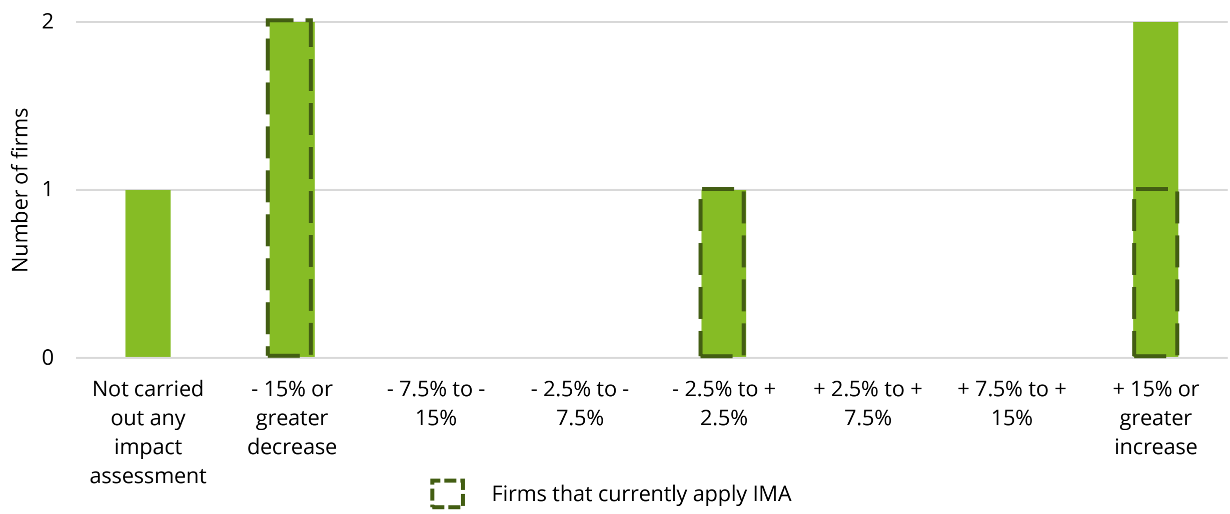
Figure 13. Planned approaches for market risk



The RWA impact assessment across all approaches is summarised in Figure 14. For one of the G-SII/O-SIIs that intended to apply the internal model approach ('IMA'), the forecast RWA impact was a reduction in the range of 7.5% to 15%, whereas the advanced standardised approach (referred to as 'ASA') impact was broadly neutral – within the -2.5% to 2.5% range. The large reduction in IMA RWA was surprising given industry expectations. This may be a consequence of IMA applying across the entire trading book under the current rules, while under fundamental review of the trading book ('FRTB') not all desks may be under IMA. The decrease could therefore be due to optimising the choice of which desks to include under IMA FRTB.

Five respondents indicated that they do not intend on reducing market risk related business as a result of the proposed rules, and one had yet to determine.

Figure 14. Expected change in overall market risk RWA

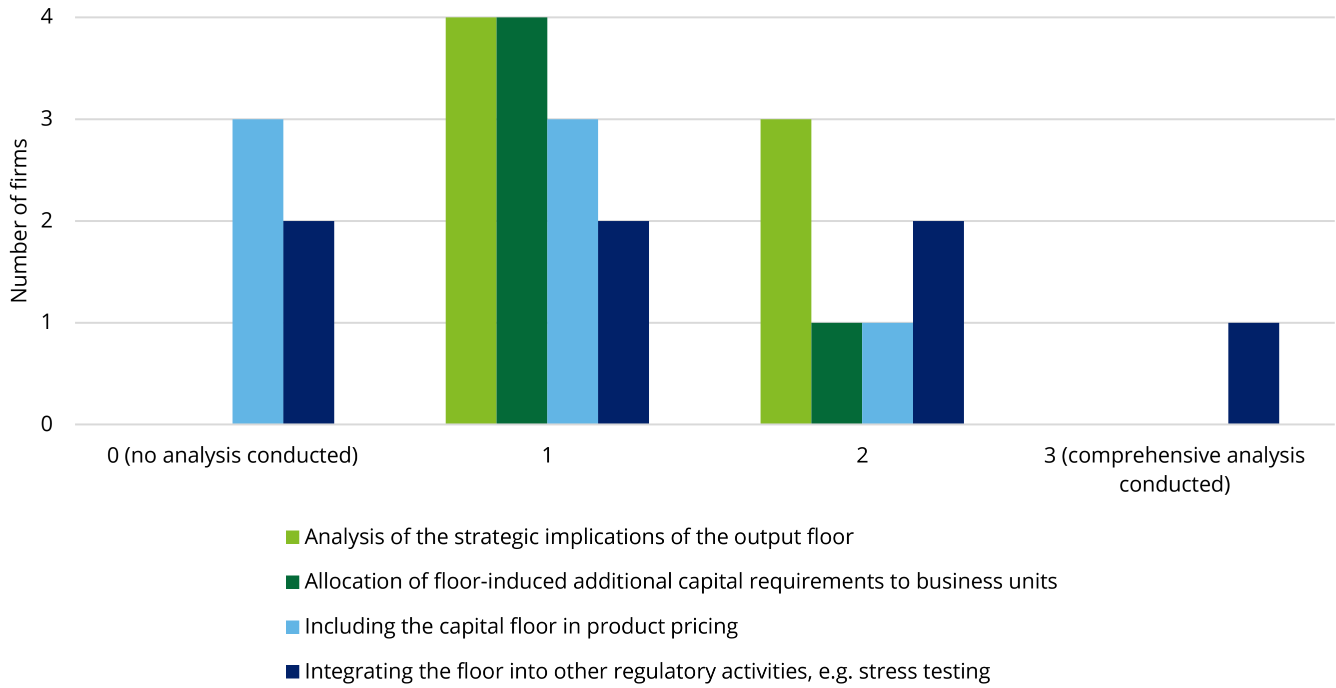


The output floor

There were seven responses to the survey from firms to which the output floor (OF) applies. Several respondents to the survey were firms that have IM permissions; however, they were not expecting to have to apply the OF in the UK. Therefore, they have not been included within this section.

Firms were asked to indicate their level of preparedness for the OF from 0 (no analysis conducted) to 3 (comprehensive analysis conducted). The results are given in Figure 15 where it can be seen that firms had begun to conduct analysis into the implications of the OF on strategy, capital allocation, pricing, and other regulatory driven aspects of their businesses.

Figure 15. How prepared is your institution in relation to the following implications of the OF?



Firms were asked whether they considered the introduction of the OF to limit the benefits derived from IMs used at their institution. The most common response was that IMs remain fully advantageous with others indicating that they still hold advantages, but not as much as without the OF.

Firms also provided an expected level of significance for the OF in relation to the following areas, the results of which are shown in Figure 16:

(i) capital allocation;

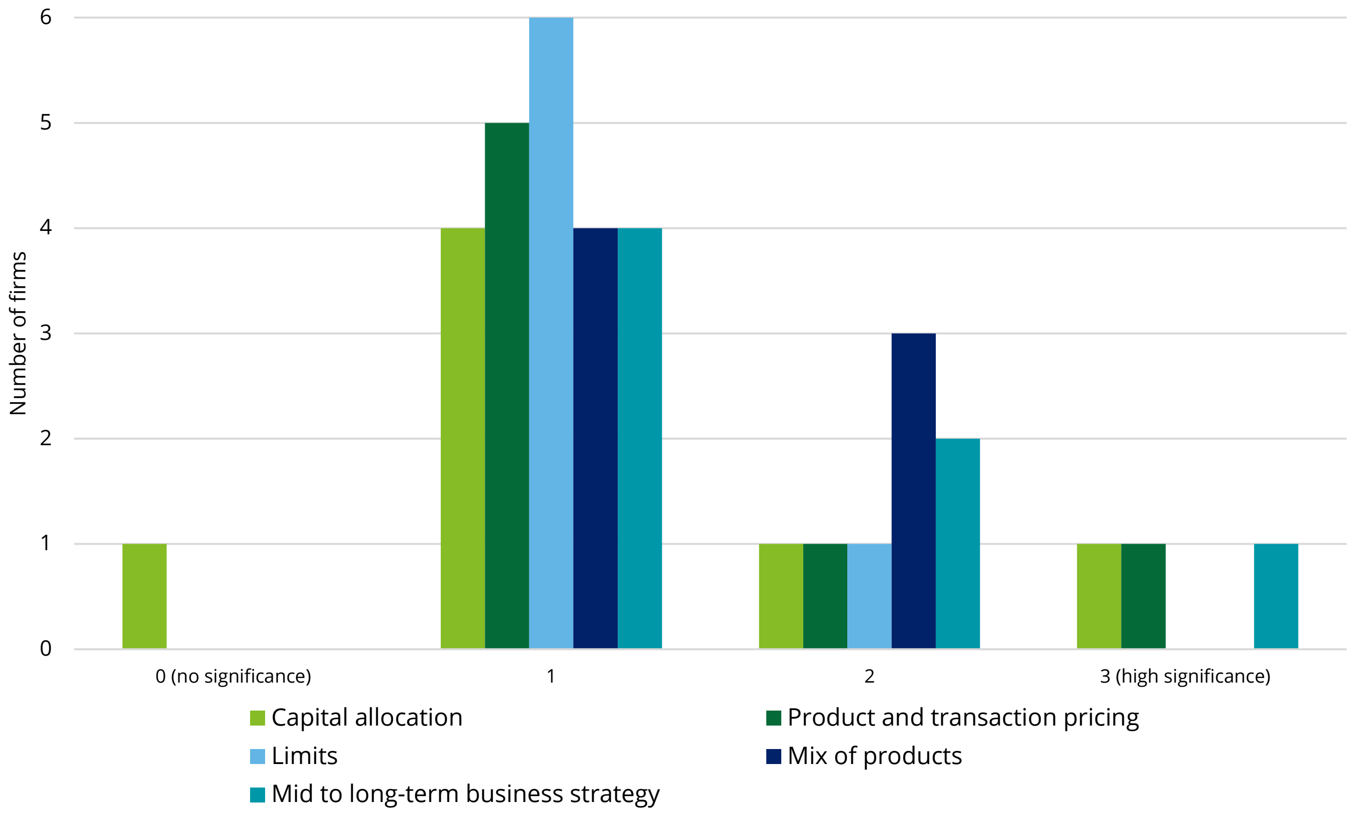
(ii) product and transaction pricing;

(iii) limits;

(iv) mix of products; and

(v) medium to long-term business strategy.

Figure 16. How significant an effect do you expect the OF to have on the following areas?



At the time the survey was conducted, the expected impact of the OF varied across the industry, but the majority of firms indicated that they did not expect significant changes from its introduction. The firms which are most likely to be bound by the floor (firms which have total RWA under all approaches less than 72.5% of their RWA calculated under SA) are typically those with residential mortgage portfolios making up a significant portion of their assets, where risk weights from modelled outputs are generally lower than under SA. For those firms who have particularly low risk residential mortgage portfolios, they may already be constrained by the leverage ratio. Firms expecting to be bound by the OF by the time of full implementation, they may change their business strategy between now and then to mitigate this impact.

Conclusion and outlook

The survey results indicate that many firms are waiting for the PRA to publish the second 'near-final' policy statement before significantly ramping up their Basel 3.1 programmes. However, given the PRA is expected to publish this in Q2 2024 and retain the proposed implementation date of 1 July 2025, this is a high-risk approach. Firms are advised to make progress on their programmes based on CP16/22 and PS17/23, while building in flexibility to be able to adjust for changes in the second 'near-final' set of rules. With this in mind, key points for firms to consider are:

- the impact of the changes will vary significantly depending on the individual firm's portfolio and strategy. There is no one-size-fits-all solution, which means that firms that have not yet assessed the effects of the new framework should do so swiftly to avoid unforeseen detrimental outcomes. This includes work on data sourcing and systems building activities which were generally less advanced than expected as of September 2023;

- for those firms whose capital requirements increase, the delay to July 2025 for implementation will allow additional time to adjust their portfolio mix and build up reserves to ensure capital ratios remain above regulatory and market expectations. The additional time will also allow firms to consider how risk appetite, risk limits, decisioning and pricing will be affected. These are areas where the industry is, in general, less advanced;

- the additional six months could allow for more/better remediation of any issues found in testing and a longer parallel run where the real-world effects of the changes to RWAs can be assessed. The last time the capital regime changed for credit, market and operational risk at the same time was when Basel II was implemented, and regulators expected firms to have a one-year parallel run period. While that is not a requirement for the implementation of Basel 3.1, firms that are able to demonstrate they have fully compliant RWA calculations ahead of the revised implementation date will be well set for conversations with their supervisors and other stakeholders. Notwithstanding this, firms should ensure that they are capturing all aspects of the credit lifecycle (e.g., risk appetite, risk limits, decisioning and pricing) in their Basel 3.1 programme and not just regulatory reporting;

- the new OF is a significant development for the use of internal ratings and risk models, as the potential capital benefit to be derived from IMs is restricted relative to SA RWA values. Given the cost of running regulatory models and the new requirements, a review of the model landscape may be advisable. Firms are permitted to revert to the SA, subject to meeting specific conditions, and this could be a feasible option for some portfolios. Additionally, IM firms should consider now needing to run RWA calculations for SA alongside IM, which will require building calculation infrastructure, upskilling and additional resource to manage oversight; and

- firms are expecting to encounter challenges from operating in multiple jurisdictions under different regulatory regimes. Firms should consider strategy for managing regulatory divergence and potential mitigants to minimise the challenges from their international presence. This could include bringing forward planned implementation dates to align to regions where compliance is sooner than the UK's 1 July 2025 (e.g., the EU, Hong Kong Monetary Authority) to avoid the risk of multiple change cycles.

Deloitte can support firms with further analysis of the potential impacts on their individual businesses, as well as interpreting the new regulatory expectations and implementing the necessary changes. Please get in touch with our experts if this would be of interest and we can discuss how we can most appropriately tailor our support to your requirements. Deloitte would like to thank all firms which participated in the survey.

List of abbreviations

BCBS	Basel Committee on Banking Supervision
CP	Consultation paper
FRTB	Fundamental review of the trading book
G-SII	Global systemically important institutions
IM	Internal model
IMA	Internal model approach
IRB	Internal ratings-based approach
LTV	Loan-to-value
OF	Output floor
O-SII	Other systemically important institutions
PRA	Prudential Regulation Authority
PS	Policy Statement
RWA	Risk weighted assets
SA	Standardised approach
SME	Small and medium-sized enterprises

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