Joint statement on Prudential Regulation Authority CP16/22 – Implementation of the Basel 3.1 standards

The implementation of Basel 3.1 must ensure a level playing field of high standards across the UK banking system. Internal ratings based (IRB) approaches to credit risk produce unduly low risk weights, and the significant fall in average risk weights among major UK banks since the global financial crisis rightly raises doubts about the adequacy of internal models.

We therefore welcome the PRA’s efforts to constrain the ability of IMs to generate lower capital requirements, and would encourage the adoption of the output floor in full to reduce the undue advantages enjoyed by larger firms using these models.

The implementation of Basel 3.1 should also be considered in the wider context of the PRA’s approach to regulating other financial institutions. The Solvency II package currently being considered effectively represents a considerable weakening of capital requirements for insurers, and as the PRA recognises, will significantly increase risk.1 We are therefore concerned that divergences between the PRA’s approach to Basel 3 and Solvency II could create opportunities for regulatory arbitrage, with insurers increasingly able to act as shadow banks, becoming conduits for investments considered risky under Basel without the appropriate capital charges.

We share concerns expressed by former Bank of England deputy governor Paul Tucker that UK regulators are failing to deal with the risks of shadow banking.2 Therefore we would support the PRA taking greater efforts to ensure equally strong regulatory standards across both banks and non-banks.

We are likewise concerned by reports suggesting that firms may be encouraged to take legal action against the PRA if the UK implementation of Basel 3.1 is deemed less ‘competitive’ than that of the European Union, which is diverging from international standards.3 We fear a repeat of issues that have surrounded the implementation of Solvency II and encourage the PRA to stand firm against any similar pressure in regards to Basel 3. We would draw your attention to calls from senior supervisors at the ECB and EBA last November for EU legislators to avoid adopting weaker standards, on the basis that strong rules ensure banks are better able to serve firms, citizens and the economy at large.4

As the PRA recognises, the Financial Services Act 2021 requires the PRA to have regard to the government’s net zero target when making Capital Requirements Regulation (CRR) rules. Furthermore, HMT’s recommendation letters to the Prudential Regulation Committee

1 Twenty per cent higher chance of insurance firms collapsing due to Solvency II reforms, Bank of England tells Treasury Committee
2 Bank of England accused of failures on shadow banking | Financial Times
4 Strong rules, strong banks: let’s stick to our commitments
clarify that regulators must have regard for delivering net zero, as part of the government’s economic strategy.

While the PRA asserts that “The Basel 3.1 standards were not designed to include specific climate risk-related measures”, it is important that any new capital rules are calibrated to reflect the high risk of fossil fuel exposures. The Basel Committee on Banking Supervision recently clarified how climate risk must be integrated into existing standards and recommended that banks should be using a conservative approach in assessing climate risks in the face of uncertainty characterising climate-related financial risks. We therefore echo growing calls for supervisors to enact a precautionary approach, where lending to new fossil fuel projects incompatible with credible net zero pathways carry a maximum 1250% risk-weighting, to reflect the particularly high risk of these investments becoming stranded assets. Furthermore, we would support the PRA adopting a 150% risk weight for exposures to existing fossil fuel reserves, in line with the standardised approach to high risk exposures in the Basel framework.

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6 Frequently asked questions on climate-related financial risks
7 Call for “one-for-one” prudential capital requirements on fossil fuel financing to prevent an economic crisis
8 CRE20 - Standardised approach: individual exposures