UK Finance

UK Finance response to the PRA's Consultation

on CP 12/25 – Pillar 2A review – Phase 1

30 September 2025

Introduction

1. UK Finance[1] welcomes the opportunity to respond to the PRA's consultation paper (CP) CP12/25 – Pillar 2A Review – Phase 1 and PS7/25 – Update to Policy Statement (PS) 9/24 on the SME and infrastructure lending adjustments. This response reflects views from a broad range of UK firms of different sizes, complexities, business models and customer bases, both domestic and international.

2. We welcome the PRA extending the consultation period for CP12/25 to 30 September 2025. We understand that the implementation date for pension risk, market risk and counterparty credit risk would now be 1 July 2026. The remaining proposals, credit risk and operational risk, would continue to align with the Basel 3.1 implementation date of 1 January 2027.

3. We highlight our concerns, and provide our recommendations, with supporting rationale, on the consultation and related frameworks. We have also reiterated issues and recommendations in relation to SDDT[2] / Basel 3.1 and suggestions for consideration as the PRA develops Phase 2 review of its Pillar 2A regime.

Key messages and Recommendations

CP12/25 – Pillar 2A review

4. **It is challenging to assess the impact of these proposals without sight of Phase 2 of the Pillar 2A consultation**. **Could the PRA please expedite the Phase 2 to assist firms with their capital planning?**

5. **Certain proposals in this consultation go beyond the Basel 3.1 framework. We strongly recommend dropping super-equivalent proposals to align with global standards to ensure a level playing field and supporting the Government's and PRA's growth and competitiveness objectives.** Examples of such super-equivalence include:

   - The proposed minimum risk weights for exposures to central governments, central banks, and regional and local authorities should be reassessed considering diversification and risk sensitivity. (paragraphs 16 to 22).
   - The 20% conversion factor (CF) for Retail unconditionally cancellable commitments (UCC) is more conservative than required under Basel 3.1 and significantly diverges from other jurisdictions, such as the US where the proposal is a 10% CF for Pillar 1 (at most) and no Pillar 2 add-on. (paragraphs 29 to 34).

6. **The IRB benchmarking framework**, critical for calibrating credit stress tests, comparing IRB and SA firms, and identifying potential over- or under-capitalisation, **should be retained or modernised rather than removed.** (paragraphs 23 to 24)

7. **Removing the refined approach without recalibrating Pillar 2A risks significant capital increase for low-risk, well-managed firms**. Basel 3.1 enhances the risk sensitivity of the standardised approach, making Pillar 1 RWAs more reflective of underlying risks. Since Pillar 2A is intended to cover risks not fully captured by Pillar 1, it

[1] UK Finance is the collective voice of the banking and finance industry. Representing over 300 firms, we're a centre of trust, expertise and collaboration at the heart of financial services, championing a thriving sector and building a better society.
[2] SDDT: Small Domestic Deposit Takers

appears counterintuitive that Pillar 2A capital requirements would increase following the removal of the refined approach. (paragraphs 25 to 27).

8. **Guidance is needed across many areas to ensure appropriate risk capture**, some examples being:
   - Current guidance on **credit risk stress testing** is overly high level and lacks sufficient detail. Several paragraphs in the consultation require clarity. (paragraphs 35 to 36).
   - Clarity on the factors that the PRA considers when setting **Pillar 2A operational risk** requirements, particularly where the assessment differs significantly from a firm's own assessment. (paragraphs 46 to 48).
   - Acceptability of applying a **single scenario test to meet multiple regulatory requirements, specifically those under Pillar 2A, OCIR[3], TPRM[4], and Operational Resilience**. (paragraphs 49 to 50).
9. **We recommend removing the double-counting across the PRA framework.** Some examples include:
   - Funded CRM[5] under FCSM[6]: applying a 20% haircut alongside a Pillar 2A capital charge. (paragraph 28).
   - Potential overlap between Pillar 2A add-ons for credit risk and those for credit concentration risk. (paragraph 40 to 41).
   - Overlap between the proposed Pillar 2A credit scenario testing and the existing Pillar 2B stress testing buffer. These buffers may lead to increases in capital requirements for the same risks. (paragraph 42).
   - Firms that lend primarily within the UK face significant additional capital requirements for UK geographic concentration. For some, this accounts for up to 70% of their total Pillar 2A capital, on top of the 2% UK-specific CCyB[7]. This penalises UK-focused lending and incentivises geographical diversification away from the UK. (paragraphs 41 and 75).
   - Market risk and CVA refinements in Basel 3.1 compared with Pillar 2A proposals. (paragraphs 54 to 55).

Other areas

10. **SME and Infrastructure lending adjustment policy does not appear to align with PRA's policy objectives. Also, the lack of consultation before the final policy statement PS7/25 contravenes the PRA's stated principle of stakeholder engagement.** We urge the PRA to ensure that the Pillar 2A offset fully neutralises the CET1 impact to avoid impact on SME and infrastructure lending, as the current proposal only provides about 75% relief and for some smaller banks, less due to insufficient Pillar 2 available for offset. **We estimate UK infrastructure loans will be priced 15–70 basis points higher than in the EU, with an average gap of 39 basis points and SME lending will range from 10-20 basis points** (paragraphs 62 to 71).

[3] Operational Continuity in Resolution
[4] Third-party Risk Management
[5] CRM: credit risk mitigation
[6] FCSM: Financial Collateral Simple Method
[7] CCyB: counter-cyclical buffer

11. **We recommend reviewing and recalibrating the HHI-based concentration risk approach considering RWA changes under Basel 3.1 as part of the phase 2.** (paragraphs 73 to 74).

12. **IRRBB[8], CSRBB[9] and Credit scenario methodologies** need an in-depth assessment. (paragraphs 77 to 78).

13. The CP does not reference that Pillar 2A capital requirements should reduce for certain risks following Basel 3.1 implementation. FRTB will better capture illiquid risks in Pillar 1 Market RWA, and the standardised approach to operational risk is an improvement compared to the current framework which will typically lead to higher RWAs. Therefore, we believe the PRA should be clarifying through this CP its intention to reduce Pillar 2A capital requirements for these risks. (paragraph 55).

14. **We recommend the PRA addresses our concerns raised in our response to CP 17/24 on SDDT, particularly credit concentration risk with respect to 3.5% add-on.** (paragraph 84 to 86).

Detailed response

SECTION I – FEEDBACK ON CP12/25 Pillar 2A review

Credit risk

15. We welcome the PRA's proposals, listed below and set out in this section specific observations and recommendations on some of these proposals:

    - Proposal 1: Proposed systemic methodology for exposures to Central governments and banks (CG/CB), regional governments and local authorities (RG/LA)
    - Proposal 2: Proposed systemic methodologies for UCCs
    - Proposal 3: Expectations for firms on the use of credit scenarios

Proposal 1: Systemic methodology for CG/CB and RG/LA

16. UK Finance appreciates the PRA's proposals for clarifying existing expectations rather than introducing entirely new obligations. However, we are concerned that certain proposals in this CP, such as the Pillar 2A risk weights for CG/CB and RG/LA exposures, represent super-equivalence, going beyond Basel 3.1 standards. The BCBS[10] set out its views on the capitalisation of these exposures and the potential for uplift in a 2017 discussion paper but did not amend the Framework. This reinforces that the PRA will apply a unique approach for UK firms.

17. Divergence from international standards undermines comparability and contradicts the PRA's secondary objective to support the UK's international competitiveness. These proposals risk disadvantaging customers of UK banks and the wider UK economy by increasing the cost of credit and potentially hampering growth.

18. The PRA should be cognisant of local liquidity requirements, particularly in emerging markets, which mandates banks to hold local government debt and/or maintain reserves with the local central bank to operate in those jurisdictions. Consequently, the proposals

8 IRRBB: interest rate risk in the banking bool
9 CSRBB: credit spread risk in the banking book
10 Basel Committee on Banking Supervision

as currently drafted could reduce UK firms' international competitiveness in these jurisdictions, due to the unavoidable increased cost of capital associated with non-discretionary sovereign exposures, compared with other banks operating under the same local requirements. UK firms would therefore be at a competitive disadvantage compared with non-UK firms when operating in overseas markets.

19. We advocate alignment with global norms, particularly with Australian Prudential Regulation Authority (APRA) and EU regimes, to ensure a level playing field. Where deviations from Basel standards are deemed necessary, the PRA should publicly provide clear and evidence-based justification.

20. We recommend that the PRA reassess the need for minimum risk weights for CG/CB and RG/LA exposures considering overall diversification and risk sensitivity and the challenges below:

    - Increased capital on non-UK exposures, especially the exposure held as part of the liquidity buffer, despite low PDs, causing unintended concentration risk.
    - Preferential treatment of UK exposures driving excessive domestic exposure, reducing diversification, and increasing the group's countercyclical buffer due to the higher UK buffer rate.
    - Increased sensitivity to UK-specific macro shocks under stress testing, with limited diversification options affecting Pillar 2B outcomes.

21. We note that the proposal to exclude CG/CB and RG/LA UK exposures is to ensure that capital requirements do not create barriers to the effective implementation of UK monetary policy. Although outside the scope of this consultation, we recommend that the PRA reconsider the treatment of such exposures under the Leverage Ratio. Under the current UK framework, the Leverage Ratio is often the binding capital constraint for many firms (unlike in the EU), which effectively imposes capital requirements on UK Government and Bank of England exposures.

22. We urge the PRA to provide more detailed insight into the specific inputs and calculations that informed the introduction of the new systematic methodologies for central banks, governments, and UCCs. Without this information, it will be difficult for firms to model the impact of these changes on their Pillar 2A requirements and to ensure that their internal risk assessments are aligned with the PRA's views. We also request that the PRA provide a comprehensive breakdown of the data points required for the new systematic credit risk methodologies. In addition, what is the expected format for data submissions, and how does the PRA intend to manage and provide feedback on data quality?

Removal of IRB benchmarking

23. We oppose removing the IRB benchmarking framework, which is essential for calibrating credit stress tests, comparing IRB and SA firms, and identifying potential over- or under-capitalisation. Removing benchmarking would widen capital disparities by eliminating a key tool SA firms use to adjust for areas where IRB firms have lower risk weights, thereby undermining risk-sensitive regulation. We urge the PRA to retain or modify the benchmarking framework. Any replacement must be balanced and comprehensive identifying both over- and under-estimation of risk to avoid undue conservatism.

24. We urge the PRA to provide a fuller cost-benefit analysis that includes the impact on smaller firms and accounts for broader benefits such as improved transparency and proportional capital outcomes.

25. We oppose the PRA's proposal to retire the Refined Methodology Approach (RA), which is currently available to relatively low-risk, well-managed firms. Removing the refined approach without recalibrating Pillar 2A risks significant capital increases for low-risk, well-

managed firms that currently benefit from it. Basel 3.1 enhances the risk sensitivity of the standardised approach, making Pillar 1 RWAs more reflective of underlying risks. Since Pillar 2A is intended to cover risks not fully captured by Pillar 1, it appears counterintuitive that Pillar 2A capital requirements would increase following the removal of the refined approach.

26. This would disproportionately affect firms on the standardised approach (‘SA firms’) and undermine risk-based capital principles.

27. The refined approach addresses SA conservatism relative to IRB. Basel 3.1 narrows this gap but does not eliminate it. Since riskiness is independent of the method used to calculate risk weights; capital requirements should reflect underlying risk, not methodology. Maintaining the refined approach would:
    - Support comparability in capital outcomes between SA and IRB firms;
    - Prevent unwarranted capital increases for well-managed SA firms;
    - Align with the PRA’s competitiveness and growth objectives.

Funded Credit Risk Mitigation: Financial Collateral Simple Method

28. We consider that applying a 20% haircut on CRM exposures alongside a Pillar 2A capital charge would result in double counting. We recommend the PRA remove the proposed haircut. Otherwise, the PRA should publish empirical analysis to support the Pillar 2A add-on.

Proposal 2: Unconditionally cancellable commitments (UCCs)

29. The proposal to raise the conversion factor (CF) for UCC was already addressed under Basel 3.1, where a 10% rate was deemed appropriate, up from 0%. It is unclear why this is being revisited, particularly given that the PRA’s definition of commitment is stricter than Basel’s, which included national discretions not applied by the PRA.

30. The PRA proposes that the Pillar 2A credit risk add-on for SA firms using retail UCCs be the difference between the Pillar 1 CF of 10% and either a prescribed CF reference point of 20%, or a CF derived by the firm from historical data. This raises competitiveness concerns for:
    - International banks (e.g. credit card portfolios), as the 20% risk weight is more conservative than required under Basel 3.1. This approach leads to a significant divergence from other jurisdictions which runs counter to the PRA’s secondary objective on growth and competitiveness. In particular, the original Basel 3 Endgame proposal in the US contained a 10% CF for Pillar 1 and no add-on in Pillar 2. We urge the PRA remain mindful of where the US Basel 3 Endgame re-proposal lands with respect to Pillar 1 CF for UCCs.
    - New/challenger banks may lack sufficient data to validate lower CFs.

    It risks constraining real-economy lending, especially under stress.

31. We understand the PRA has compared SA CCFs to IRB CCFs in isolation, which we believe this is inappropriate. While it is true that some IRB firms may use higher modelled CCFs than those mandated under SA, even after the uplift to an effective 20% CCF, it is very likely IRB firms will have lower risk weights for equivalent exposures overall, particularly for customers with stronger credit histories. Effectively increasing the SA CCF via this Pillar 2A add-on will exacerbate the competitive advantage of IRB firms for customers with stronger credit, impeding the ability of SA firms to compete for these customers.

32. The calibration of the conversion factor for UCCs is based on "qualifying revolving exposures," which are defined as exposures to individuals. This approach may not be appropriate for retail SMEs and could, as a result, reduce the availability of working capital facilities to businesses, thereby hampering UK competitiveness and long-term growth. We recommend that if a 20% conversion factor is to be applied to SME exposures, this should be separately justified and assessed as part of the cost–benefit analysis, including consideration of alignment with the PRA's secondary objective.
33. We recommend that the PRA reconsider the competitiveness impact of a 20% floor in light of global standards and apply proportionality and supervisory judgment where historical validation is not feasible.
34. The Credit Risk add-on for Retail UCC will be calculated based on paragraph 2.35 of the CP i.e. [Notional × (20% or CCF derived – 10%) × applicable risk weight]. Could the PRA clarify whether the resulting nominal risk-weighted amount should then be multiplied by the Pillar 1 minimum capital requirement percentage or by the Pillar 2A requirement when computing the capital requirement add-on?

Proposal 3: Credit scenarios

35. We believe that the PRA guidance on credit risk stress testing is too high level and lacks sufficient detail on the severity of expected stress scenarios. Without further specificity, including sample scenarios and key parameters, firms will interpret severity differently, making consistent Pillar 2A outcomes unachievable. We recommend that the PRA provide clarification.
36. More granularity is needed on key parameters - PD, LGD, severity - to improve transparency and consistency. While flexibility for firms' individual circumstances is welcome, greater specificity, particularly on PD increases and curing rates, would support more consistent implementation alongside an HPI scenario. Further guidance requested on the model governance expectations.
37. We recommend allowing offsets between new systematic approaches for sovereigns and unsecured consumer credit and other Pillar 2A methods, including credit scenarios and internal models. Systematic approaches always produce positive add-ons, while other methods can indicate Pillar 1 overestimation, resulting in negative adjustments. If these methods show total Pillar 1 credit risk, excluding portfolios under systematic approaches, is overstated, that offset should be allowed. This would improve risk sensitivity and ensure Pillar 2A capital reflects true risk rather than methodological differences.
38. We recommend that the PRA remove the proposed restrictions on using proxy IRB models in place of credit scenario modelling. This would allow these models to be applied across all portfolios, provided firms justify their use in the ICAAP. Many firms currently have approved A-IRB models for portfolios that will transition to the standardised approach under Basel 3.1 (e.g., sovereigns). These A-IRB models should be permitted for use in Pillar 2A instead of credit scenario modelling. The PRA should also clarify that firms may continue to use economic capital models as an alternative to credit scenarios (paragraphs 2.49–2.59).
39. "*2.54: Firms should ensure their own credit scenarios are more severe than the historical average peak-to-trough change in key macroeconomic scenario variables in Bank Capital Stress Tests or equivalent benchmark scenarios published by the PRA."* This represents a significant shift for firms not directly involved in the Bank of England's stress tests, particularly smaller banks or subsidiaries of overseas groups, which could face considerable new burdens. While we agree that firms should use severe credit scenarios, they should also have flexibility to tailor these to their specific business models and risk profiles. This may involve using different variables than those in the BoE's scenarios, particularly where institution-specific risks are more relevant.

40. *"2.51 In order to ensure that scenarios are designed consistently across firms, the PRA proposes to introduce clear expectations for firms on the use of credit scenarios in ICAAPs. This would inform the PRA's assessment of whether firms are adequately capitalised against credit risk across exposures on the SA, reflecting the idiosyncratic risks they face."* It is unclear whether the proposed credit scenarios would capture credit concentration risk, and we are concerned about the potential overlap between Pillar 2A add-ons for credit risk and those for credit concentration risk. Firms could face significantly higher capital requirements due to both the new systematic elements and credit concentration risk. We recommend that Pillar 2A components are clearly delineated and mutually exclusive to avoid double counting.

41. The new Pillar 2A credit stress-testing approach will, in practice, capture geographical concentration risk, leading to a double counting of capital requirements. The proposal requires firms to model high-severity tail events that are even more severe than "*the historical average peak-to-trough change in key macroeconomic scenario variables in Bank Capital Stress Tests or equivalent benchmark scenarios published by the PRA*." Given that the current Bank of England scenario is already calibrated in line with the 2008 Global Financial Crisis, featuring a 35% fall in commercial real estate prices, a 28% fall in residential property prices, as well as sharp declines in GDP and higher unemployment, it is evident that such a scenario already captures UK-specific geographical concentration risk, particularly for firms with a domestic focus.

42. We recommend clarification on whether the use of credit scenarios in Pillar 2A (Chapter 2) is limited to traditional credit products, or if firms are expected to extend these scenarios to cover counterparty credit exposures as well. In many cases, banks have shared counterparties across both direct lending and counterparty credit risk exposures. As such, we expect the scenario design may need to consider both types of exposures. This consideration is also relevant for the application of MERW[11] in Chapter 2.

43. We appreciate clarification on whether there will be overlap between the proposed Pillar 2A credit scenario testing outlined in the consultation and the existing Pillar 2 stress testing buffer (P2B). We urge the PRA to clarify how these buffers will interact, to ensure consistency and avoid unnecessary increases in capital requirements for the same risks.

Proposal 4: Reporting

44. We welcome the proposals to streamline and decommission templates and certain update templates

Operational risk

45. We welcome the proposals listed below relating to operational risk and set out some, challenges and areas requiring clarification:
    - Proposal 1: Expectations on scenario analysis for all firms
    - Proposal 2: More transparency on the Pillar 2A methodology
    - Proposal 3: Good practices in maintaining a robust measurement
    - Proposal 4: Clarification of changes to FSA 072-075 templates

46. We remain concerned that operational risk continues to be treated as a 'black box,' with capital requirements that are difficult to reconcile, explain, or justify. We recommend that the PRA provide more clarity on the factors it considers when setting Pillar 2A

[11] MERW: Minimum Effective Risk Weights

requirements, in addition to the details stated in 3.10, particularly where the assessment differs significantly from a firm's own assessment. This clarification should identify whether discrepancies are due to weaknesses in scenario analysis, methodological differences, or data limitations. More detailed feedback will help firms improve their ICAAP and ensure alignment with the PRA's expectations.

47. The PRA should clarify whether Pillar 2A capital for operational risk will decrease following the introduction of the new standardised approach for operational risk under Basel 3.1. We recommend that the PRA introduce an offset so that the increase in Operational Risk RWA from the implementation of Basel 3.1 is not applied against Pillar 2A, like the adjustment for the loss of the SME Supporting Factor and the Infrastructure Factor.

48. We have listed specific areas below with our recommendations and highlighting where more clarity is needed:

- Replace ambiguous terms such as "significant firm" with a more clearly defined classification, such as the Potential Impact Categories used in the PRA's supervisory framework.
- Disclose the Pareto distributions and shape parameters referenced in the PRA's modelling approach. This would help firms, particularly those with limited internal loss data, align more closely with supervisory expectations.
- Define the PRA's expectations around "severe but plausible" scenarios (3.6 and 2.18B, Appendix 4).
- How the PRA expects firms to aggregate operational risk scenarios to determine an appropriate capital requirement. More specific guidance would support consistent application across firms.
- Whether insurance can still be used as a capital offset, particularly considering footnote 26a in Appendix 4.
- The weighting the PRA applies to different assessment metrics outlined in paragraph 3.10, and whether feedback on these elements will be provided through the TCR[12] letters.
- When firms should assess "potential or probable" operational risk events under Pillar 2A versus Pillar 2B to avoid capital overlap (2.18c(v), Appendix 4).
- Confirm that reporting capital by Basel Event Type refers to Level 1 rather than Level 2 classification, and whether firms may use internal taxonomies with clear mapping to Basel Level 1 (2.18c(iii), Appendix 4).
- Confirm whether ICAAP assessments should be based on gross loss net of direct recoveries for consistency with FSA Form and CoRep submissions (3.15).
- Provide clearer expectations on what constitutes acceptable scenario validation using loss data, especially where data is sparse, one-off, or non-repeatable (2.18G(v), Appendix 4).
- Provide guidance on whether credit boundary losses should be excluded from FSA Forms 072/073, and how to handle pre-ring-fencing losses between RFBs and NRFBs.
- Resolve potential inconsistencies between CoRep reporting (accounting view) and ICAAP capital assessments (event view), as raised in the Basel 3.1 consultation (3.15).

[12] TCR: Total Capital Requirement

49. We recommend providing guidance on the acceptability of applying a single scenario test to meet multiple regulatory requirements, specifically those under Pillar 2A, OCIR, PRM and Operational Resilience.

50. We suggest that the PRA consider the potential resource and capacity constraints firms face during scenario testing. Given the reliance on technology teams for executing stressed scenarios, the ability to reuse key data outputs across multiple regulatory obligations would help reduce the operational burden. This approach would enable firms manage resource demands more effectively while still meeting regulatory expectations.

Pension risk

51. We welcome the proposals listed below relating to pension risk and make one observation below:

    - Proposal 1: Remove the two published stress scenarios
    - Proposal 2: Reduce firms' Pillar 2A pension risk assessments and lighten reporting

52. *"4.14 The PRA proposes to reduce firms' risk assessments and lighten reporting requirements where firms meet one of these two criteria, which it considers important determinants of a firm's pension risk. However, for the avoidance of doubt, trustees of pension schemes should decide if meeting either criterion is a suitable outcome for the scheme in question."* We understand that the PRA does not expect trustees to be involved in firms' ICAAP or Pillar 2A submissions as that would amount to trustees being shadow directors of firms, but we acknowledge that funding and investment decisions do need trustee approval. Could the PRA please confirm agreement.

53. We recommend that the PRA provide additional guidance on how the assessment of pension schemes, including residual risks following a buy-in (such as credit risk relating to the insurer counterparty) should be reflected in ICAAP. In particular:

    - Where should this assessment be reflected in the ICAAP? The current interpretation leans toward including it in the Pensions Risk section of the ICAAP rather than, say, in the counterparty credit risk section.
    - What does the PRA's expectation of "assessment of residual risks" mean in practice? The current interpretation leans toward a qualitative assessment considering the strength of the insurer or insurance regime, contractual protections and FSCS protection. If a quantitative assessment is expected instead, is there any guidance on a proposed approach or key principles to assess? The FSCS protection implies there is very limited residual risk for the bank. Specifically, the current position is that the FSCS covers 100% of the pension liabilities if the insurer defaults. Therefore, risk could only arise from the timing of payments to pensioners that may require the bank to step in and provide a short-term loan to the fund to cover the required payment until such time as the FSCS is able to make the payment to the UKRF.

Market risk and counterparty credit risk

54. We list below specific areas with our recommendations and highlighting where more clarity is needed:

    - Whether refinements in Market risk and CVA[13] will result in a reduction in Pillar 2A where double-counting may occur, as laid out in PS 9/24, paragraph 5.45.

[13] CVA: Credit Valuation Adjustment

- On consistent application of risk weights between credit exposures and counterparty credit risk.
- Whether scenarios and minimum risk weights apply equally across exposure types.

55. In the ‘near-final B3.1 policy statement’, the PRA stated that Pillar 1 refinements in Market risk and CVA would lead to reductions in Pillar 2A, and that any potential double counting in Pillar 2A (e.g., for illiquid risk and concentration risk) would be removed in future publications. Since CP12/25 has not provided further clarification on this point, we request updates on how these interactions will be addressed in upcoming phases.
56. We understand that the CP focuses on disclosures of the PRA’s SREP approach to market risk capital and does not introduce new expectations. For example, we interpret that there is no requirement to capitalise intraday risk, since market risk capitalisation is based on end-of-day exposure. This aligns with the FRTB, which only requires monitoring of intraday risk. We therefore view the reference to intraday risk in this section as good practice for identifying and monitoring exposures, rather than as a new capitalisation requirement.
57. As stated in the CP, firms are required to hold additional market risk capital to cover gap risk. Further clarification would be appreciated regarding the definition of “gap risk,” and could you confirm whether this definition is intended to align with the treatment of gap risk under the FRTB?
58. As the syndicated leverage loan guidance is new to the industry, we suggest that the PRA provide more time for the industry to implement the changes.

Other aspects

59. **Regulatory reporting**: Could the PRA clarify how the proposed simplification of regulatory reporting in this CP ties in with the Future Banking Data (FBD) Review project?
60. **Materiality**: The paper suggests that the expected impact of these proposals is below its materiality threshold. However, firms’ experience is that Pillar 2A is almost always material.
61. **ICAAP cycle and timelines**: Could the PRA clarify how the ICAAP cycle should operate in practice to incorporate the revised Pillar 2 methodologies alongside Basel 3.1 requirements? Should ICAAP 2027 be based on Basel 3.1 or 2.5?

SECTION II – ASSESSMENT AND FEEDBACK ON OTHER AREAS

PS7/25 – Update to PS9/24 on the SME and infrastructure lending adjustments

62. The lack of consultation before the final policy statement was released directly contravenes the PRA's stated principle of stakeholder engagement.

63. The proposed policy results in a higher CET1 requirement than retaining the Pillar 1 SMESF[14]. The PRA has earlier stated that the new Pillar 2A adjustments will "ensure that the removal of the support factor does not result in an increase in overall capital requirements for SME exposures" (PS 9/24, 1.16). As such, this policy statement does not achieve that aim. While total capital requirements may remain unchanged, CET1 requirements rise, raising costs for SME and infrastructure lending. As CET1 is the highest quality and most expensive form of capital, this impact is significant.

64. The SMELA[15] Pillar 2A reduction applies 56.25% to CET1, with the remainder to additional Tier 1 and Tier 2 capital. However, removing the SMESF results in a CET1 capital relief loss of approximately 75%, due to buffers like the CCoB[16] and CCyB requiring full CET1 coverage. As the Pillar 2A offset restores only about 56% CET1, a shortfall remains. To align treatment with the effective loss of CET1 relief, we recommend recalibrating the Pillar 2A offset to apply closer to 75% CET1. This would better reflect the full structure of the capital stack and the practical impact of CET1-only buffer requirements, while ensuring that macro buffers remain available to absorb broader system-wide shocks.

65. Moreover, the SMELA is only fully effective when there is sufficient Pillar 2A to offset against. This will increase the cost of lending to SMEs, potentially reducing the volume of credit available to customers, which could hinder SME growth and viability in the UK.

66. This could also impact the UK's international competitiveness. UK SMEs may face higher financing costs. We estimate UK infrastructure loans will be priced 15-70 basis points higher than in the EU, with an average gap of 39 basis points and SME lending will range from 10-20 basis points.

67. We urge the PRA to ensure the Pillar 2A offset fully neutralises the CET1 impact to avoid these consequences. We also recommend that the CAF[17] be calibrated to neutralise the CET1 impact.

68. In the example below, a firm faces £2.1 billion in additional capital requirements following a £12 billion increase in RWAs due to the removal of the SME supporting factor. This leads to a £1.5 billion increase in CET1 requirements, which would be equivalent to c.£22bn of lending capacity at 75% risk weight/9% CET1 requirement (CET1 requirement being 8% Pillar 1 * 56.25% + 2% CCyB + 2.5% CCoB).

69. Using the PRA's methodology for setting a CAF to the change in RWAs, a CAF of 17.5% is required. However, this would mean that the offset only produces £1.2 billion (56.25% of £2.1 billion) of CET1 benefit compared to the £1.5 billion detriment from higher RWAs.

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[14] SMESF: SME Support Factor
[15] SMELA: SME Lending Adjustment
[16] CCoB: Capital Conservation Buffer
[17] Capital Adjustment Factor

Illustrative Scenario and Impact Assessment

	With SME supporting factor		Without SME supporting factor		Change
RWA	**£100bn**		**£112bn**		**£12bn**
Pillar 1	8.0%	£8.0bn	8.0%	£9.0bn	£1.0bn
Pillar 2A	4.0%	£4.0bn	4.0%	£4.5bn	£0.5bn
Combined Buffer	4.5%	£4.5bn	4.5%	£5.0bn	£0.5bn
PRA buffer	1.0%	£1.0bn	1.0%	£1.1bn	£0.1bn
Total	**17.5%**	**£17.5bn**	**17.5%**	**£19.6bn**	**£2.1bn**
of which CET1					
Pillar 1	4.5%	£4.5bn	4.5%	£5.0bn	£0.5bn
Pillar 2A	2.3%	£2.3bn	2.3%	£2.5bn	£0.3bn
Combined Buffer	4.5%	£4.5bn	4.5%	£5.0bn	£0.5bn
PRA buffer	1.0%	£1.0bn	1.0%	£1.1bn	£0.1bn
Total	**12.25%**	**£12.3bn**	**12.3%**	**£13.7bn**	**£1.5bn**

70. A solution for this is to consider the CAF at the Total Capital Ratio level only and introduce an offset to Pillar 2B for the remainder of the CET1 detriment, as, as set out below. This creates two adjustments for Pillar 2A and Pillar 2B. (This could equally be applied to the combined buffers where banks do not have sufficient Pillar 2A or Pillar 2B.)

Alternative Proposal

Pillar 2A adjustment	
∆RWA (A)	£12.0bn
Capital Adjustment Factor[18] (B)	12.0%
Pillar 2A adjustment (C = A x B)	**£1.4bn**
Pillar 2B Adjustment	
CET1 increase from SF removal (D)	£1.5bn
CET1 benefit from Pillar 2A adjustment (E = C * 56.25%)	£0.8bn
Pillar 2B adjustment required (D - E)	**£0.7bn**

[18] *Capital adjustment factor set to TCR of firm (i.e., excluding buffers)*

71. We recommend the PRA provide clarification on whether systemic buffers will continue to be included in the CAF calculation following the Day 1 adjustment. While they are referenced in paragraph 2.19 as part of the Day 1 components, they are not mentioned in paragraph 2.20, which outlines the ongoing approach under the C-SREP.

Recommendations for Phase 2 of Pillar 2 review

72. It is challenging to assess the comprehensive of these Pillar 2A Phase 1 proposals without sight of Phase 2 of the consultation. Could the PRA please accelerate the publication of Phase 2 of the Pillar 2A review to assist firms with their capital planning? We would also like to highlight the specific issue set out below, which we strongly urge the PRA to address in Phase 2.

Credit concentration

73. We recommend reviewing and recalibrating the HHI-based concentration risk approach considering RWA changes under Basel 3.1. We encourage a broader reassessment of the methodology, including:
    - Reviewing the number and definition of sectors used.
    - Considering alternative methods for assessing concentration risk.
    - Revisiting the treatment of geographic regions (e.g. whether the UK should be split into sub-regions)
74. We also recommend completely removing geographic concentration risk from Pillar 2A to avoid potential double counting between the HHI methodology and the proposed Pillar 2A credit stress test. This would also help support the objective to support long term UK growth as it would encourage UK-focussed firms to lend across the whole UK.
75. Firms that lend primarily within the UK face significant additional capital requirements for UK geographic concentration. For some, this accounts for up to 70% of their total Pillar 2A capital, on top of the UK-specific CCyB[19] of 2%. This penalises UK-focused lending and incentivises geographical diversification away from the UK. Further, the proposed Pillar 2A credit stress test will also likely result in holding additional capital for UK geographic concentration. We recommend recalibrating the treatment of UK geographic concentration so that the framework continues to promote diversification and financial resilience, but without unduly disincentivising domestic lending, which remains strategically important for the UK economy.
76. We recommend that the PRA undertake a holistic review of the capital stack, assessing overlaps between Pillar 2A and other areas of the prudential framework, notably credit concentration risk.

IRRBB and CSRBB

77. We recommend that the PRA include IRRBB in the next consultation, particularly providing further details on the capital treatment of swap spread risk and which elements of IRRBB policy will apply to mid-sized firms.
78. We recommend that the PRA provide guidance on CSRBB. We set out below our recommendations highlighting current challenges:

[19] CCyB: counter-cyclical buffer

- We understand that the PRA has provided bilateral feedback to some firms to hold Pillar 2A capital for CSRBB, including assets in the liquidity portfolio regardless of accounting treatment. The PRA's methodology appears to conflate market risk VaR[20] with IRRBB, potentially leading to a significant capital requirement, even for gilts. This contradicts broader policy messages encouraging banks to hold gilts for use in central bank facilities. We are concerned this issue was not addressed in the Pillar 2A review, given its potential impact.
- Amongst SME and Challenger banks, there is lack of consistency in PRA's approach - requiring different banks to calculate capital for CSRBB using different VaR-type assessments with different parameters (holding period, look-back period etc) and with some banks not required to calculate capital.

79. We anticipate that Phase 2 of the consultation will provide further insights into the design and application of credit scenarios. Such guidance would support a standardisation across firms on Pillar 2A scenario development. It would be helpful if the PRA could provide more information on:
    - MEVs[21].
    - Expected severity levels.
    - Expectations regarding the choice and treatment of idiosyncratic scenarios.
80. We recommend that the PRA clarify how it intends to manage the significant increases in Pillar 1 capital requirements under stress scenarios, which appear more severe under Basel 3.1 and the SDDT than under the current regime.
81. We recommend that the PRA provide guidance on regulatory expectations for the governance of models used in Pillar 2A assessments. This would support effective planning and resource allocation for impact assessments.
82. In relation to Basel 3.1, we urge the PRA to provide a clear mapping document showing how the outputs of the new Pillar 1 framework will be used in the new Pillar 2A methodologies.

SDDT - CP7/24

83. Pending the PRA's policy statement on the SDDT capital regime (expected in Q4 2025), we would like to reiterate the concerns in **UK Finance response to CP7-24 simplified SDDT capital regime**: .
    - Credit concentration risk is a significant component of firms' Pillar 2A requirements. However, firms cannot fully assess its treatment under Basel 3.1 as the relevant methodology has not yet been consulted on.
    - We are seeing increased capital requirements due to the inclusion of credit concentration risk on non-lending assets such as operational leases, investment properties, and right-of-use (ROU) assets. These fixed assets have been brought into scope under the proposed SDDT credit concentration risk methodology through the inclusion of "other exposures" in the 3.5% wholesale add-on.
84. The 3.5% wholesale category would as proposed also see a significant increase in capital requirements for exposure to SMEs, where they do not qualify as retail, despite these

[20] VaR: value at risk
[21] MEVs: Macroeconomic and Environmental Variables

exposures being significantly granular in nature and as such receiving a much lower capital add-on under the current HHI methodology.

- The inclusion of covered bonds, equities, and other non-lending assets is similarly inappropriate and should be excluded. The increase in capital is further exacerbated by the removal of the previously used refined methodology, resulting in a less risk-sensitive approach.
- The current SDDT proposal appears to serve as a simplistic proxy for concentration risk rather than a meaningful quantification. Pillar 2A is intended to address risks not already captured under Pillar 1, yet the blanket 3.5% add-on for wholesale non-regulatory residential asset classes lacks clarity on the specific risks it aims to address.
- If this requirement were treated as a Pillar 1 charge, a risk weight of 143.75% would be needed to achieve the same capital effect, compared to 100% under the non-SDDT approach (assuming other assets are excluded). This significantly increases capital requirements for essential fixed assets that firms cannot easily reduce, creating a structural capital burden that SDDT firms cannot mitigate.

85. We recommend that the PRA:

- Only includes lending portfolios (i.e., borrower-related exposures) in SDDT Credit Concentration Risk and does not include fixed assets held on balance sheet.
- Provide empirical evidence to support the 3.5% calibration, particularly if non-lending exposures remain in scope.
- Clarify the rationale for the differential between the 1% retail and 3.5% wholesale add-ons, given that wholesale credit risk is already addressed under Pillar 1.

Stress scenario Impacts under Basel 3.1 and SDDT

86. In a system-wide economic stress scenario involving a severe reduction in property prices, firms would experience a decline in capital resources due to credit loss provisions. At the same time, they would face rising capital requirements because of higher LTV ratios under the SA. Although this occurs under both the current and Basel 3.1/SDDT regulatory regimes, the impact is expected to be significantly more severe under Basel 3.1/SDDT. While the OCR[22] has been calibrated to remain broadly consistent across regimes for the industry as a whole, Basel 3.1/SDDT may increase nominal capital requirements (due to nominal RWA inflation and fixed capital buffer percentages), thereby reducing surplus capital. We urge the PRA to provide a more comprehensive cost-benefit analysis that includes plans to mitigate potentially excessive capital requirements to support growth and economic recovery.

87. As a result, in such a stress scenario, firms under Basel 3.1/SDDT would exhaust surplus capital more quickly than under the current regime. This could lead to firms implementing more aggressive capital conservation strategies, potentially worsening and prolonging the economic stress.

88. We recommend that the PRA consider how, in such situations, the TCR could be adjusted more rapidly for the industry, beyond the regular C-SREP cycle (which for some firms occurs only every three years and may increase to every five years under the proposals). For example, this could involve recognising credit losses already realised or provided for to a greater extent, thus limiting further downside risk.

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[22] OCR: Overall Capital Requirement

Engagement

89. We appreciated the opportunity to share our draft key messages at an industry roundtable on 22nd September and would be pleased to facilitate further discussion with members.

90. UK Finance is content with the PRA publishing this consultation response on its website.

Responsible Executive

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