

* Striking a Balance

*The Bank of England's Prudential Regulation Authority recently finalised its Basel 3.1 framework for implementation at the start of 2027. **David Bailey**, executive director for prudential policy, talks to IQ about the importance of global consistency and the need to strike a balance in regulating fast-changing markets*

IQ: Driven by technological innovation, economic shifts and geopolitical risks, the pace of change in financial markets is accelerating. How do you think prudential policy should adapt to ensure the regulatory framework remains appropriate and relevant without creating unnecessary burdens or complexity?

David Bailey (DB): We are in a particularly fast-moving external environment, whether that's the risk environment or the level of technological change we're seeing. Regulation needs to keep up to ensure the right level of resilience while also being responsive to external developments. It's really important that we ensure firms can continue to innovate and that markets are vibrant and competitive while maintaining that level of resilience that is necessary for sustainable growth. That's always been our approach, but what's changed in recent years is that the Prudential Regulation Authority (PRA) has taken on a new secondary objective to promote competitiveness and growth within the UK, subject to alignment with international standards. That sits beneath our primary objective of ensuring the safety and soundness of firms.

As we either write new rules to implement international standards or review existing rules in light of market developments, there's now a premium on making sure we're thinking not just about resilience but also making sure the rules are proportionate, efficient and effective. As an example, we took steps when implementing Basel 3.1 to tailor the rules on lending to small- and medium-sized enterprises to reflect the needs of the UK market. We've also taken steps to simplify other rules that had got overly complex and disproportionate to the underlying risks.

It's also important that we work actively to support the safe adoption of innovation across markets so firms can deliver new products, operate more efficiently and offer

their services to new markets. That's good for the resilience of firms, the resilience of markets and economic growth. For the PRA, there is a balance between supporting new ideas and making sure that's done in a responsible and resilient way. We have a choice when we're faced with innovation – we can write rules early and give firms clarity, recognising the rules may need to be adapted as developments happen, or we can take a step back, seek to understand innovation, see how it fits within our existing regulatory framework and only write rules if we think they're really necessary. There's a balance there, but the PRA's approach to technologies like artificial intelligence (AI) has generally been more principles-based. We are watching, we're engaging with firms, but we haven't rushed to write new rules.

IQ: This is a critical year for the completion of the Basel III reforms, with the US, EU and UK taking steps to finalise the rules for implementation. How important is global consistency in the timing and content of the rules, and do you think this can still be achieved?

DB: Yes, I do think it's still possible. International standards support international activity and cross-border trade, and they are incredibly important to what we do at the PRA and more broadly at the Bank of England, but also in the context of the UK's role as a global financial centre. We were heavily involved in developing the Basel III rules and it was very important that we implemented them in a robust way.

However, a commitment to international rules doesn't mean every jurisdiction copies them word for word. The exact implementation depends on national legislative structures and processes, and there is always some room for tailoring,



particularly for businesses that are more domestically focused. We will see some differences in implementation across different jurisdictions to reflect those differences. Where I think consistency matters most is for those rules that relate to cross-border activity. That's why there has been so much focus on the trading book rules, and we delayed implementation in the UK because we wanted to try to achieve a high level of consistency with other large financial centres.

IQ: Does the Basel Committee have a responsibility to revisit those parts of the framework where divergence is most evident, suggesting possible flaws in the original framework? Is there still a role for an international body to set bank capital standards, or will this increasingly now be driven by individual regulators?

DB: It's important we put the amount of divergence from international standards into context – it's actually a small set of the overall Basel III standards. That doesn't mean it's not important, but I think there are many more areas of alignment than divergence.

The Basel Committee does look at differences through

its regulatory consistency assessment programme, where it does targeted evaluations on how member jurisdictions have implemented the standards. For example, its assessment of the UK implementation of the large exposures standard and the net stable funding ratio (NSFR) was published last year, showing we were largely compliant with international standards. That particular assessment also flagged that there were some areas where several jurisdictions had taken common approaches to diverging from the NSFR, and the Basel Committee said in November that it would do a targeted review of that standard, focusing on those specific areas. That's a good example of where the committee has identified jurisdictions all deviating from the standard in a common way. I think there is an important role for the Basel Committee to monitor implementation and, where it sees divergences, seek to understand whether that means any adjustments are needed.

The Basel Committee and other standard-setting bodies will continue to have a really important role to play, both in developing new standards where they're necessary – for example, on crypto assets – and making sure that existing standards are implemented effectively, as well as reviewing them where necessary.



“It’s really important that there is a credible standardised approach and if firms are going to move to internal modelling of their market risk exposures, then that should represent a step-up in the accuracy of their risk measurement and management”

→ **IQ:** The PRA recently finalised the Basel 3.1 package, with implementation set for January 1, 2027, but the internal models approach (IMA) for market risk was delayed until the following year. What issues have you identified in the design and calibration of the IMA, and how do you think these might be addressed?

DB: It’s important that the option to use internal models remains, but the Fundamental Review of the Trading Book (FRTB) was designed with a number of objectives. The first was to make sure there’s a very clear boundary between what is in the trading book and what is in the banking book, so the market risk framework is applied only to the instruments it’s designed for. Secondly, it was designed to create a really effective standardised approach for market risk, which would be a credible alternative to internal models. And thirdly, it sought to make sure the standards for banks using internal models are robust, so they do a really good job of assessing the risks they’re running. On the first two goals, I think the FRTB is in a really good place, which is why we’ve chosen to move ahead with implementation.

On internal models, the standard focuses on the right things – it’s more a question of calibration and making sure the bar is set at the right level for firms to be incentivised to improve their models so they use those rather than the standardised approach. That calibration is complex and it needs data, which has been scarce up until now. So, we’re taking the extra time that is needed and we’ve got firms actively developing their models and some using them in practice. We’ve therefore got some more data we can use, which will give us a better sense of whether elements like the profit-and-loss attribution test and non-modellable risk factors are correctly calibrated. Those are the elements we’ll be looking at as we finalise and implement the IMA within the UK, while also having regard to other jurisdictions.

Overall, it’s really important that there is a credible standardised approach and if firms are going to move to internal modelling of their market risk exposures, then that should represent a step-up in the accuracy of their risk measurement and management. That’s why we have put so much focus on making sure the IMA is appropriately calibrated. It is important the most sophisticated banks that run complex books have ways of making sure they can accurately model their risks.

IQ: Non-bank financial intermediation (NBFI) has been under the spotlight in recent years as policymakers have sought to address perceived vulnerabilities in the context of recent market shocks. The Bank of England has carried out one system-wide exploratory scenario (SWES) exercise on public markets and is working on a second on private markets. What have you learnt from these exercises and how do they inform policy considerations?

DB: They’re a really important part of the stress testing framework that is run by our financial stability colleagues. The SWES we have already run provided us with valuable insights into how sterling markets and participants will react – both individually and collectively – to stress. For example, while NBFI resilience has improved in certain respects in recent years, the actions some participants took in the SWES, such as selling into falling markets, tended to amplify the stress. It also highlighted that the banking sector wasn’t necessarily likely to be able to provide all the additional repo that non-banks were looking for in a stress scenario. That strengthens the case for policies to enhance repo market resilience – we issued a discussion paper (DP) on this topic last year. The exercise also highlighted that firms weren’t necessarily factoring in the correct expectations about what would happen to initial margin

and repo lines in periods of stress. Those are important dynamics for us to understand so we can investigate what steps we need to take to ensure the right level of resilience. More generally, the results highlighted the value of system-wide stress testing, which is why we initiated a second SWES, focusing on private markets.

IQ: The Bank of England's DP on reforms to enhance the resilience of the gilt repo market explored policy measures such as central clearing and minimum haircuts on non-cleared trades. What are the next steps, and how will you ensure any policy changes don't increase the cost of funding or adversely affect market liquidity?

DB: We put the DP out there to stimulate a discussion about steps to improve gilt market resilience, and we had really good engagement from a wide range of market participants, which shows there is a shared interest in making sure gilt markets remain resilient in all market conditions. We're reflecting on the responses to determine the right way forward, but we're not committing to a single policy option at this stage. We will make sure any policy proposals are designed and calibrated carefully, with industry input, and are implemented smoothly with an effective transition.

IQ: The Basel Committee has said it will expedite a review of its prudential standard for banks' crypto-asset exposures, while the Bank of England recently consulted on the regulation of sterling-denominated systemic stablecoins. How should regulators strike a balance between putting appropriate guardrails in place for these instruments and not constraining the potential to realise greater efficiencies and reduce risk in financial markets?

DB: There is great potential here to support new products, greater resilience, competition, innovation and growth. We need to understand and support any innovation to make sure it happens in a responsible and safe way, which means focusing both on the potential they bring – for example, to improve payments and settlement – but also any new risks they present. My team's role is to update the banking framework to help firms manage the risk from any crypto-asset exposures they hold, but I also work closely with colleagues who are developing the systemic stablecoin regime. We need to understand how firms are going to be using crypto assets and what innovations they want to develop so we can support their efforts in a safe way.

The Basel framework for crypto assets was published several years ago and the approach was to allow tokenised versions of traditional assets to be treated pretty much

as the underlying traditional assets, but to take a more conservative approach for new types of crypto assets, both from a prudential and operational perspective. We've been considering how we would go about implementing that standard, but we're also conscious the world has moved on since the standard was drafted. We've actually seen real adoption of the products and we've learned from the experience of those markets developing, so we understand the risk they present a bit better. The targeted review is important, and it will inform our next steps in implementing the crypto framework in the UK. Ultimately, it's important our framework is neutral from a technology perspective, so when assets present the same risk, we should aim to achieve the same regulatory outcome.

IQ: In what areas of financial markets and supervision do you think AI, distributed ledger technology (DLT) and tokenisation could realise the greatest benefits, and what role should regulators play?

DB: These are exciting technologies that have the potential to be really transformative in terms of the efficiency of firms, operations, productivity and the services that are provided. From our surveys and engagement with firms, we can see a growing number are actively experimenting with AI within their own operations, although not necessarily for the highest risk use cases at this stage. We're also actively using AI in some of our internal processes at the PRA and we already see the benefits in terms of the speed it brings to certain tasks. It's really important that we think hard about how we can support increased adoption in a responsible way, both within our own operations and in the industry.

With DLT, there are important opportunities to fundamentally rewire parts of the financial system, and it opens up concepts like 24/7 operations and near-instant settlement. It can effectively make transactions cheaper, faster and much more efficient, while also improving the operational resilience of key processes.

Given the benefits, we need to understand these technologies and help firms experiment with them and develop them. Last year, we launched our AI Consortium to bring industry participants together, and I've also engaged in a series of roundtables with firms to discuss how it sits with our current rulebook and any barriers or frictions that we need to think about in the context of our future work. We can provide safe places for firms to trial technologies, such as our Digital Security Sandbox, which we've had really good engagement with. These are all important ways in which we can understand both the benefits and the risks of new technologies and work out how the benefits can be realised in a resilient and safe way. 

| This interview was conducted in late January, 2026