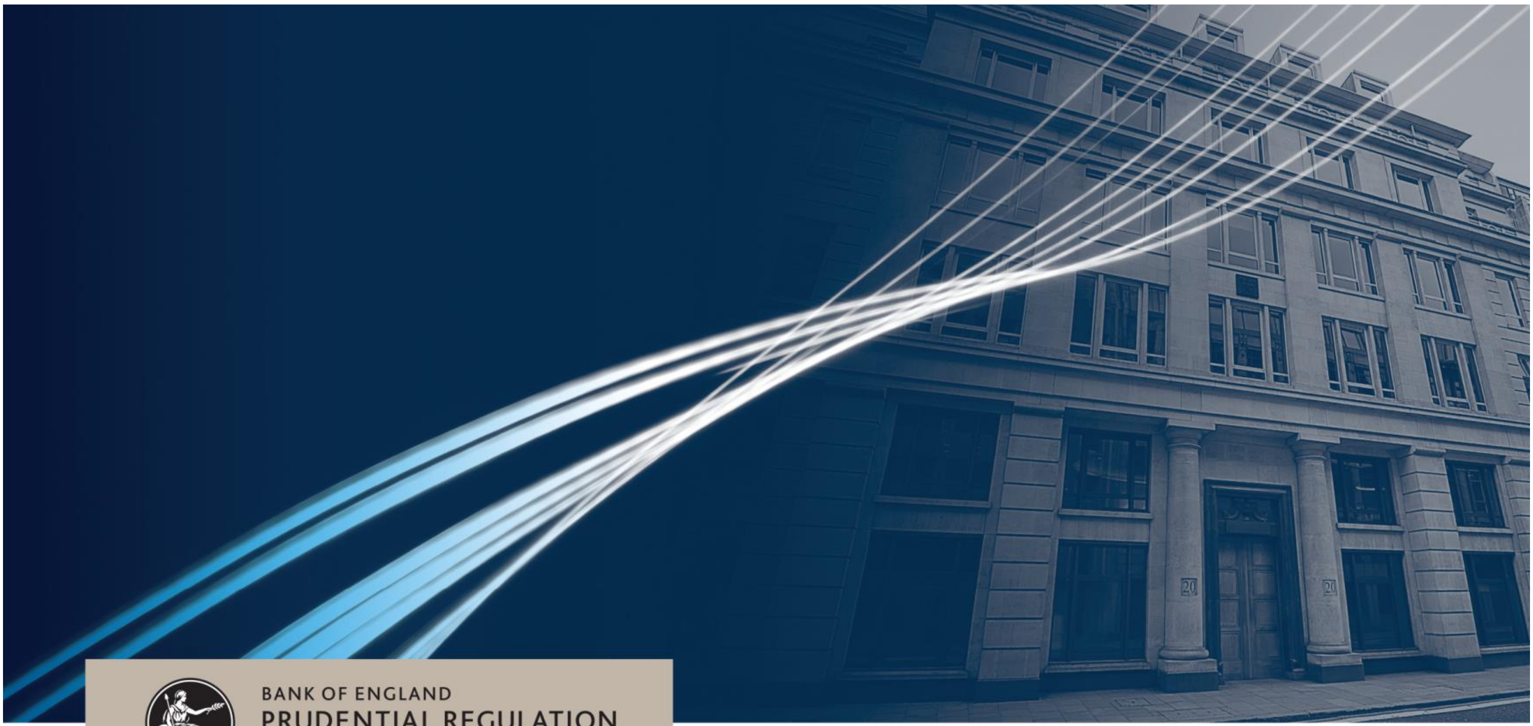

BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

Consultation Paper | CP2/20

Pillar 2A: Reconciling capital requirements and macroprudential buffers

February 2020

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Responses are requested by Thursday 30 April 2020.

Please address any comments or enquiries to:
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1 Overview

1.1 On Monday 16 December 2019, the Financial Policy Committee (FPC) raised the level of the UK countercyclical capital buffer (CCyB) rate that it expects to set in a standard risk environment from in the region of 1% to in the region of 2%.[1] This was a structural change in the level of the CCYB in that standard risk environment, rather than in response to a change in the FPC's view of the risk environment. In this consultation paper (CP), the Prudential Regulation Authority (PRA) proposes to reduce variable Pillar 2A capital requirements to take account of the additional resilience associated with higher macroprudential buffers in a standard risk environment.

1.2 The proposals in this CP only relate to the 1 percentage point structural increase in the UK CCyB in the standard risk environment CCyB announced by the FPC on Monday 16 December 2019. Any subsequent changes in the UK CCyB rate, up or down, brought about by changes in the FPC's view of the prevailing risk environment would not be reflected in changes in Pillar 2A.

1.3 The proposals in this CP would make amendments to Supervisory Statement (SS) 31/15 'The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)'[2] (Appendix 1).

1.4 The CP is relevant to PRA-authorised UK banks, building societies and PRA-designated investment firms ('firms').

1.5 This CP should be read in conjunction with the Bank of England (the Bank) FPC's December 2019 Financial Stability Report (December 2019 FSR).[3]

Background

1.6 The PRA sets Pillar 2A capital requirements for risks which are either not captured or not fully captured under the Capital Requirements Regulation (575/2013) (CRR). It assesses those risks as part of the supervisory review and evaluation process (SREP), in light of both firms' internal capital adequacy assessment process (ICAAP) and the PRA's Pillar 2A capital methodologies, as set out in SS 31/15 and PRA Statement of Policy 'The PRA's methodologies for setting Pillar 2 capital'[4] (SoP).

1.7 In 2017, the PRA implemented refinements to Pillar 2A[5] whereby the PRA carries out an overall assessment of the level of capital that would be sufficient to ensure the sound management and coverage of firms' risks. This informs the PRA's assessment in setting Pillar 2A.

1.8 As set out in the December 2019 FSR, the FPC raised the structural level of the UK CCyB rate that it expects to set in a standard risk environment from in the region of 1% to in the region of 2%. This means that whenever the system is in a standard risk environment, the UK CCyB will be set at 2%. Given that the current risk environment is judged to be standard, the FPC therefore also judged a 2%

1 'Financial stability report', December 2019: https://www.bankofengland.co.uk/financial-stability-report/2019/december-2019.
2 January 2020: https://www.bankofengland.co.uk/prudential-regulation/publication/2013/the-internal-capital-adequacy-assessment-process-and-supervisory-review-ss.
3 (Page 36): https://www.bankofengland.co.uk/financial-stability-report/2019/december-2019.
4 January 2020: https://www.bankofengland.co.uk/prudential-regulation/publication/2015/the-pras-methodologies-for-setting-pillar-2-capital.
5 October 2017: https://www.bankofengland.co.uk/prudential-regulation/publication/2017/refining-the-pra-pillar-2a-capital-framework.

UK CCyB rate to be appropriate. It therefore raised the UK CCyB rate from 1% to 2%. This will take effect on Wednesday 16 December 2020.

1.9 In July 2018, the European Banking Authority (EBA) published updated guidelines on the SREP process (EBA/GL/2018/03), which included the reconciliation of Pillar 2A requirements with buffer and macroprudential requirements. These set out that 'in determining additional own funds requirements (or other capital measures), competent authorities should reconcile the additional own funds requirements with any existing capital buffer requirements and/or macroprudential requirements addressing the same risks or elements of those risks'.

1.10 As set out in the SoP, the PRA considers all capital buffers to be usable in a stress.[6] Where the buffers are used to absorb losses in a stress, the PRA would be content for firms to rebuild their buffers over a reasonable period. The PRA would take into account the amount by which buffers have been used, the type of stress experienced and its expected duration. The PRA does not expect firms to maintain additional capital to avoid using the PRA buffer or combined buffers in a stress.[7]

Purpose

1.11 The proposals in this CP clarify the considerations relating to macroprudential buffers that the PRA takes into account when it carries out an overall assessment of the level of capital that would be sufficient to ensure the sound management and coverage of firms' risks.

1.12 The proposals in this CP are part of a package that includes the review of the structural level and balance of capital requirements for the UK banking system undertaken by the FPC,[8] including the increase in the UK CCyB rate that the FPC expects to set in a standard risk environment; and the Bank's clarification that, in resolution, it expects all debt that is bailed in to be written down or converted to common equity tier 1 (CET1). The purpose of this package, as outlined in the December 2019 FSR, is to:

(a) **Increase resilience** – while leaving the overall loss absorbing capacity for the banking system broadly unaffected, the changes would shift the balance of that capacity towards higher quality Tier 1 capital.

(b) **Improve responsiveness of capital requirements to economic conditions** – by shifting the balance of capital requirements from minimum requirements that should be maintained at all times towards buffers that can be drawn down as needed, these changes would mean that banks would be more able to absorb losses while maintaining lending to the real economy through the cycle.

(c) **Enhance resolvability** – The Bank's intention, in resolution, to write down or convert debt to CET1 capital would make resolved banks more resilient to further losses, supporting their resolution and minimising the wider economic costs of their failure.

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6 Paragraph 9.5, SoP 'The PRA's methodologies for setting Pillar 2 capital': https://www.bankofengland.co.uk/prudential-regulation/publication/2015/the-pras-methodologies-for-setting-pillar-2-capital.

7 The combined buffer is made up of: Systemic buffers, capital conservation buffer and the countercyclical capital buffer.

8 December 2019 FSR.

Implementation

1.13 The proposed implementation date for the policy proposed in this CP is Monday 6 July 2020. The PRA proposes to apply the Pillar 2A reduction, where applicable, at the same time or before the 2% UK CCyB rate comes into effect on Wednesday 16 December 2020.

1.14 The proposals set out in this CP have been designed in the context of the UK's withdrawal from the European Union and entry into the transition period, during which time the UK remains subject to European law. The PRA will keep the policy under review to assess whether any changes would be required due to changes in the UK regulatory framework at the end of the transition period, including those arising once any new arrangements with the European Union take effect.

1.15 The PRA has assessed that the proposals would not need to be amended under the EU (Withdrawal) Act 2018 (EUWA). Please see PS5/19 'The Bank of England's amendments to financial services legislation under the European Union (Withdrawal) Act 2018'[9] for further details.

1.16 The draft SS attached to this CP should be read in conjunction with SS1/19 'Non-binding PRA materials: The PRA's approach after the UK's withdrawal from the EU'.[10]

1.17 As these changes relate to EU Guidelines, they should be read in conjunction with the joint Bank and PRA Statement of Policy (SoP) 'Interpretation of EU Guidelines and Recommendations: Bank of England and PRA approach after the UK's withdrawal from the EU'.[11]

Responses and next steps

1.18 This consultation closes on Thursday 30 April 2020. The PRA invites feedback on the proposals set out in this consultation. Please address any comments or enquiries to CP2_20@bankofengland.co.uk.

9 April 2019: https://www.bankofengland.co.uk/paper/2019/the-boes-amendments-to-financial-services-legislation-under-the-eu-withdrawal-act-2018.

10 April 2019: https://www.bankofengland.co.uk/prudential-regulation/publication/2019/non-binding-pra-materials-the-pras-approach-after-the-uks-withdrawal-from-the-eu-ss.

11 April 2019: https://www.bankofengland.co.uk/paper/2019/interpretation-of-eu-guidelines-and-recommendations-boe-and-pra-approach-sop.

2 Proposals

Proposal to reduce Pillar 2A

2.1 In line with the EBA SREP guidelines, the PRA proposes to reflect the additional resilience associated with higher macroprudential buffers in a standard risk environment in Pillar 2A, which can absorb losses from the same risks currently capitalised in Pillar 2A.

2.2 In particular, the PRA proposes to reduce Pillar 2A capital requirements with the aim of keeping total regulatory loss-absorbing capacity (LAC), defined as minimum requirement for own funds and eligible liabilities (MREL) plus buffers, broadly constant. The PRA would assess the appropriateness of any reduction to ensure that the remaining Pillar 2A provides sound management and coverage of the risks to which each firm is exposed. As such, though the intention of the proposed policy is to keep LAC broadly unchanged, there is no automatic reduction for individual firms.

2.3 For firms whose MREL exceeds total capital requirements (TCR), ie Pillar 1 + Pillar 2A, the PRA proposes to reduce variable Pillar 2A capital requirements by 50% of the firm specific increase in the UK CCyB rate in a standard risk environment. To illustrate: the increase in the standard risk environment UK CCyB rate announced by the FPC is 1 percentage point. An MREL firm (as described in the beginning of this paragraph) with a 90% UK CCyB pass-through[12] rate would see a reduction in total variable Pillar 2A capital requirements, subject to the overall assessment mentioned in paragraph 2.2, of 1 percentage point multiplied by 90% multiplied by 50% = 0.45 percentage points of risk-weighted assets (RWAs).

2.4 The PRA proposes to make an <u>additional</u> reduction of 50% of the firm-specific UK CCyB pass-through rate for firms whose MREL is equal to TCR, and which are considered to have a low risk profile by the PRA. The PRA considers that this would facilitate effective competition without prejudice to its general objective. In assessing a firm's overall capital adequacy when considering this further reduction, the PRA would also take into account the remaining capital necessary to ensure the sound management and coverage of the risks. While the PRA will apply supervisory judgement to the facts of each individual case, the PRA proposes to apply additional reductions that would keep a firm's variable Pillar 2A capital requirements above 1%.

2.5 The PRA proposes to only reduce the variable component of total Pillar 2A capital requirements. The reduction would not apply to the fixed elements of Pillar 2A, to ensure capital remains available to meet claims arising from pension obligations. Other fixed add-ons, which may be set for IT risk for instance, would similarly not be reduced. This is consistent with the PRA's refined approach to Pillar 2A.[13]

2.6 The proposed reduction would only be relative to the 1 percentage point increase in the standard risk-environment CCyB announced by the FPC on Monday 16 December 2019. Any subsequent changes in the UK CCyB rate occasioned by changes in the FPC's view of the prevailing risk environment would not be reflected in Pillar 2A. Pillar 2A would also, in general, only be adjusted at SREP assessments; so changes in a firm's pass-through rate would, in general, not be reflected until the firm's next SREP assessment.

12 The weight applied to the countercyclical buffer rate in the UK, calculated as the ratio of total own fund requirements relating to credit exposures in the UK to total own funds requirements relating to all credit exposures.

13 Paragraph 5.12A, SS31/15: https://www.bankofengland.co.uk/prudential-regulation/publication/2013/the-internal-capital-adequacy-assessment-process-and-supervisory-review-ss.

2.7 The PRA recognises that the proposed reduction in Pillar 2A cannot keep LAC unchanged for individual firms. This includes firms for which LAC is determined by the leverage ratio, and firms that do not have sufficient Pillar 2A to fully benefit from the proposed reduction. Also, for firms whose MREL exceeds capital requirements but is not equal to two times TCR (over the MREL transition period and end state) will not see a reduction in MREL sufficient to keep LAC constant, even if they benefit in full from the Pillar 2A reduction. This includes firms that are subject to internal MREL above capital requirements due to the scaling (see paragraphs 2.19-2.21).

2.8 On balance, after considering a range of options, the PRA believes that the proposed policy is the fairest approach across firms having regard to both its general objective and its secondary competition objective (SCO).

2.9 As described in more detail in paragraphs 3.12 – 3.17, the PRA has chosen an approach which it believes most facilitates competition without prejudice to its general objective. By aiming to keep overall LAC constant, eligible smaller firms (whose MREL tends to equal TCR) would receive a larger Pillar 2A reduction than larger firms (whose MREL exceeds TCR). The capital that can be used to meet TCR is subordinated to, and therefore tends to be more expensive than, eligible debt that can be used to meet MREL exceeding TCR. Since eligible smaller firms would receive a reduction of 100% of their UK CCyB pass-through rate in Pillar 2A, but larger firms would only receive a reduction of 50% of their UK CCyB pass-through rate in Pillar 2A, smaller firms' funding costs would be reduced relatively more than larger firms'. Alternative options, for example to reduce Pillar 2A by 50% of the firm-specific UK CCyB pass-through rate for all firms, would, in the PRA's opinion, not have facilitated competition to the same extent.

2.10 The PRA recognises that smaller firms with small or zero variable Pillar 2A capital requirements who benefit from the PRA's refined approach to Pillar 2A would not receive the full,[14] or any, benefit of this policy. However the TCR cannot be lower than the Pillar 1 requirement, and the PRA believes that the refined approach to Pillar 2A itself already facilitates competition in the banking sector. It does so through reducing the risk that the differences in risk weights between the standardised approach to credit risk and the internal ratings based approach (IRB) that could distort incentives in the mortgage market, especially for asset classes that are considered lower risk.

2.11 In order to implement the proposed changes, the PRA proposes to update 'SS31/15 'The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)', (as set out in Appendix 1).

2.12 The PRA proposes to apply the reduction where applicable on or before the 2% UK CCyB rate comes into effect on Wednesday 16 December 2020.

Interactions with the Leverage and MREL frameworks

2.13 The PRA recognises that the proposed changes to the capital framework may increase individual firms' LAC where banks are bound by existing UK leverage ratio requirements. The PRA views the leverage ratio as an essential part of the capital framework Without a leverage ratio requirement, a bank with low average risk-weights would be able to fund its assets with a substantial amount of debt and only very little equity, a structure that would be particularly susceptible to small errors in estimated risk-weights.

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14 Policy Statement 22/17 'Refining the PRA's Pillar 2A capital framework', October 2017: https://www.bankofengland.co.uk/prudential-regulation/publication/2017/refining-the-pra-pillar-2a-capital-framework.

2.14 For resolution to be feasible and credible, UK firms with a bail-in or partial-transfer resolution strategy are required to maintain sufficient resources in a form that can be used in the event of a failure to absorb losses and allow for recapitalisation (MREL). These requirements go beyond the going-concern capital that is set by the PRA.

2.15 The proposals in this CP would not amend or otherwise affect the framework according to which MRELs are set by the Bank as the UK resolution authority.

Interim MREL

2.16 Under the proposed Pillar 2A reduction, firms subject to MREL of twice TCR would see their LAC broadly unchanged in end-state MREL.

2.17 The Bank, as the UK resolution authority, set a transition period until Saturday 1 January 2022 for firms to meet their end-state MREL. The transition period is intended to allow firms flexibility over the timing of changes to their capital structures and to ensure that firms make progress towards meeting their end-state requirements. Interim MRELs set during the transition period are lower than twice the going-concern capital requirements and may not be a function of Pillar 2A. The increase in the UK CCyB rate will therefore be higher than the reduction of these firms' MREL (if any) due to the proposed amendments to Pillar 2A and will result in an increase of LAC during the transition period. However, no firm's LAC is expected to be higher in the transition period than at the end-state.

2.18 The PRA proposes not to make a larger Pillar 2A adjustment during the transition period. Any additional Pillar 2A reduction would not benefit firms whose 2021 interim MREL is not a function of Pillar 2A (for example, because it is based on the leverage ratio, or a fixed proportion of RWAs). Therefore, a larger Pillar 2A reduction would not keep LAC constant for these firms. At the same time, reducing Pillar 2A would reduce going-concern capital for these firms by more than the PRA considers appropriate given the greater systemic importance of those firms compared to the firms who are eligible for the further reduction of Pillar 2A described in paragraph 2.4.

Internal MREL

2.19 Internal MREL is set by the Bank for material subsidiaries, as defined in paragraphs 7.1-7.3 of the Bank's MREL SoP.[15] The Bank expects that internal MREL for a material subsidiary (including RFBs) will be scaled in the range of 75% to 90% of the full amount of external MREL that the material subsidiary would otherwise be required to maintain if it were itself a UK resolution entity.

2.20 Due to scaling, these firms would see a more limited benefit from the reduction in Pillar 2A. For these firms, LAC would be expected to increase by approximately 10 basis points-25 basis points multiplied by their UK CCyB pass-through rate.

2.21 The PRA proposes not to make a further reduction in Pillar 2A to reflect the effects of internal MREL scaling. The PRA considers that 'material subsidiaries' will only have a very small additional increase in cost relative to firms subject to external MREL in excess of capital requirements, as the slightly larger benefit the latter firms receive is in a relatively less expensive form of capital.

15 June 2018: https://www.bankofengland.co.uk/-/media/boe/files/paper/2018/statement-of-policy-boes-approach-to-setting-mrel-2018.

3 The PRA's duty to consult

3.1 The PRA has a statutory duty to consult when introducing new rules and, when not making rules, has a public law duty to consult widely where it would be fair to do so. When doing so, the PRA provides the following in relation to the proposed policy:

- a cost benefit analysis;
- an explanation of the PRA's reasons for believing that making the proposed policy is compatible with the PRA's duty to act in a way that advances its general objective, insurance objective (if applicable), and secondary competition objective;
- an explanation of the PRA's reasons for believing that making the proposed policy is compatible with its duty to have regard to the regulatory principles; and
- a statement as to whether the impact of the proposed policy would be significantly different to mutuals than to other persons.

3.2 The Prudential Regulation Committee (PRC) should have regard to aspects of the Government's economic policy as recommended by HM Treasury.[16]

3.3 The PRA is also required by the Equality Act 2010 to have due regard to the need to eliminate discrimination and to promote equality of opportunity in carrying out its policies, services and functions.[17]

Cost benefit analysis

3.4 The PRA, in forming its view on the fairest policy, considered this policy proposal to reduce P2A together with the wider package of announcements in the December 2019 FSR.

3.5 Paragraph 1.12 sets out the benefits of the proposals against which any costs need to be considered. Notably, the proposed approach would increase the quality of capital in firms' capital requirements: firms must meet 56% of Pillar 2A but 100% of the CCyB with the highest quality capital, common equity tier 1 (CET1). As such, the higher UK CCyB and reduced Pillar 2A would lead to a net increase in CET1 requirements, increasing the safety and soundness of firms in a standard risk environment even as LAC is held broadly constant. And, the higher UK CCyB rate set in a standard risk environment, which provides releasable capital to absorb losses in stress without cutting lending, improves the responsiveness of capital requirements to economic conditions.

3.6 Costs are expected to stem from changes in the LAC for individual firms including, during MREL transition and for firms subject to internal MREL above TCR; changes in the quality of capital required; and the impact on competition.

Higher loss-absorbing capacity for individual firms

3.7 While the overall loss-absorbing capacity for the banking system would be broadly unaffected by the package of changes introduced in the December 2019 FSR, the proposals would result in some

16 Section 30B of the Bank of England Act 1998.
17 Section 149 of the Equality Act 2010.

increases in overall loss-absorbing capacity for some firms. Two groups of firms would face higher costs:

(i) firms without sufficient Pillar 2A, and/or firms who are in principle eligible for the additional P2A adjustment but who do not meet the requirements in paragraph 2.4 (as a broad guide approximately 13% of firms receive no Pillar 2A reduction and, in total, approximately 50% of firms do not receive the full benefit);

(ii) firms for whom the proposed P2A reduction does not result in keeping overall LAC constant, for example because they are leverage constrained in going- or gone-concern capital space, or because they are subject to internal MREL (approximately 9% of firms).

3.8 The PRA considers that the overall increase in LAC for these firms is either very low or cannot be mitigated by the PRA, for example where firms do not have Pillar 2A or Pillar 2B capital requirements, or where doing so would prejudice the PRA's general objective.

3.9 There are no additional reporting costs, as all firms already calculate their UK CCyB pass-through rate as part of COREP C 09.04.[18]

Higher quality of capital needed to meet the CCyB

3.10 In addition to the change in the level of LAC held by firms, there are two additional costs to firms from the changes introduced in the December 2019 FSR:

(i) the enhanced resilience from the shift to higher quality capital described in paragraph 1.11 imposes a cost on firms. The estimated increase in aggregate Tier 1 requirements and buffers is 0.35 percentage points, from around 13.7% to 14% of RWAs. Most firms can meet this increase with existing capital resources;

(ii) this is in line with the FPC's assessment for appropriate system-wide Tier 1 requirements in a standard risk environment,[19] and as such the PRA considers the prudential benefit of this policy to outweigh the small incremental cost to firms.

Impact of the MREL transitional requirements

3.11 As most firms are due to meet their end-state MREL in 2022, the proposals would increase firms' LAC requirements in the interim period before end-state MRELs apply (albeit to a level that is no higher than end state LAC requirements applicable from 2022). We do not expect this change to increase costs materially for firms.

Impact on competition

3.12 In considering how best to update the Pillar 2A capital framework to take account of the additional resilience associated with higher macroprudential buffers in a standard risk environment, the PRA has sought to design its policy proposal so as to best facilitate effective competition in markets for services provided by PRA-authorised firms while not prejudicing the advancement of its general objective, which is to promote the safety and soundness of PRA-authorised persons.

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18 Row 110, Template C0.04, COREP, https://eba.europa.eu/sites/default/documents/files/documents/10180/1396357/31673d6a-a46c-4c8c-a887-8717a6ab0f93/Annex%202%20(Solvency).pdf.

19 'Financial stability report', December 2019: https://www.bankofengland.co.uk/financial-stability-report/2019/december-2019.

3.13 The 50% reduction in Pillar 2A is in principle to be applied to all firms. Although the reduction would be subject to supervisory discretion for individual cases, there should not be a material impact on competition. For firms not subject to MREL in excess of TCR and with a low risk profile, there is an additional reduction of 50% of the firm-specific UK CCyB pass-through rate.

3.14 The PRA considers that smaller firms would not have been at a material competitive disadvantage to larger firms if the PRA applied only a 50% reduction in Pillar 2A. There are a number of reasons for this assessment:

(i) the additional benefit larger firms with MREL equal to twice TCR would get from an additional reduction in their MREL , would have been small given the relatively low cost of MREL eligible debt;

(ii) larger firms are subject to other constraints such as leverage which mean not all of them receive an additional reduction in MREL debt requirements; and

(iii) larger firms have access to capital markets that allow them to raise capital instruments more cheaply to meet Pillar 2A requirements, which reduces the benefit of any Pillar 2A reduction for them. In contrast, smaller firms tend to meet all their Pillar 2A requirements in the highest and most expensive form of capital, which increases the benefit they receive from the Pillar 2A reduction.

3.15 These considerations are particularly relevant when comparing smaller firms with ring-fenced banks, who generally have similar CCyB pass-through rates to domestically focused UK firms and therefore see a similar impact from the CCyB increase.

3.16 That said, in considering policy options the PRA has judged that it can actively facilitate competition, while not prejudicing the promotion of the safety and soundness of the firms it regulates, by granting eligible smaller firms an additional downward Pillar 2A adjustment.

3.17 The PRA has also considered competition impacts on firms that benefit from the refined approach to Pillar 2A, and therefore are unlikely to benefit fully or at all from the proposed Pillar 2A reduction, in comparison to firms who would benefit from the proposed Pillar 2A reduction. The PRA considers that firms benefitting from the refined approach could already operate with reduced or without variable Pillar 2A capital requirements, which facilitates competition between them and larger firms.

Compatibility with the PRA's objectives

3.18 The proposal is compatible with the PRA's general objective to promote the safety and soundness of firms it regulates, because aggregate loss absorbing capacity would, in standard times, remain broadly unchanged as a result of the proposed reduction in Pillar 2A capital. Given the difference in the minimum quality of capital the CCyB and Pillar 2A must be met with, overall CET1 requirements would increase in standard times.

3.19 The PRA also judges that, conditional on a firm having exhausted its now larger buffers, the proposed reduction in Pillar 2A would not materially affect the remaining resilience provided by minimum requirements.

3.20 The PRA has assessed how the proposed policy facilitates effective competition when discharging its general functions in a way that advances its primary objectives.[20] See the section above on the 'impact of competition' to see how the policy meets the secondary competition objective (SCO).

Regulatory principles

3.21 In developing the proposals in this CP, the PRA has had regard to the regulatory principles.[21] Of these, the PRA considers the following two to be particularly relevant to this proposal:

- The principle that a burden or restriction which is imposed on a person should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden. The PRA has followed this principle when developing the proposals outlined in this CP. The proposals avoid excess loss absorbency in minimum requirements, compared to the current framework, caused by the higher standard risk environment UK CCyB.

- The principle that the regulators should exercise their functions as transparently as possible. The clarification proposed in this CP is intended to increase transparency over the PRA's Pillar 2A setting.

Impact on mutuals

3.22 This policy is applied equally to banks and buildings societies. However, Pillar 2A tends to be lower for building societies for a number of reasons, including that they are more likely to benefit from the refined approach to Pillar 2A. As a result, they are more likely not to benefit fully from the proposed reduction in Pillar 2A. The PRA considers that the impact of the proposed changes could reduce Pillar 2A capital requirements for 52% of building societies.

3.23 The PRA expects that approximately 14% of the building societies would expect to benefit from a full reduction, 38% to receive part of the reduction and 48% to have insufficient Pillar 2A to receive any reduction.

HM Treasury recommendation letter

3.24 HM Treasury has made recommendations to the Prudential Regulation Committee (PRC) about aspects of the Government's economic policy to which the PRC should have regard when considering how to advance the PRA's objectives and apply the regulatory principles.[22]

3.25 The aspects of the Government's economic policy most relevant to the proposals in this CP are:

(i) **Competition -** The government is keen to see more competition in all sectors of the industry, particularly retail banking. This includes minimising barriers to entry and ensuring a diversity of business models within the industry.

(ii) **Growth -** The government wishes to ensure financial services markets make a positive contribution to sustainable economic growth in the UK economy in the medium and long term,

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20 FSMA, s2H(1).
21 See s.3B of the Financial Services and Markets Act 2000 (FSMA).
22 Information about the PRC and the recommendations from HM Treasury are available on the Bank's website at https://www.bankofengland.co.uk/about/people/prudential-regulation-committee.

through the facilitation of finance for productive investment and as a productive sector of the UK economy.

(iii) **Competitiveness** - The government wishes to ensure that the UK remains an attractive domicile for internationally active financial institutions, and that London retains its position as the leading international financial centre. The government considers that achieving this aim in a manner that is consistent with robust institutions and a resilient system would support its aims for sustainable economic growth.

3.26 Aspects (i) and (ii) have been considered in the 'compatibility with the PRA's objectives', 'regulatory principles' and 'impact on competition' sections above. Where consideration has been given to the aspects that extend beyond the PRA's objectives and the regulatory principles, these are set out below.

Competitiveness

3.27 The proposals in this CP would support the Government's wishes through the combined purpose of the outcomes from the capital review, through increased resilience, improved responsiveness of capital requirements to economic conditions and enhanced resolvability.

Equality and diversity

3.28 The PRA considers that the proposals do not give rise to equality and diversity implications.

Appendix: Draft amendments to Supervisory Statement (SS) 31/15 'The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)'

In this appendix deleted text is struck through and new text is underlined.

…

5 The SREP

…

5.12 The PRA will set Pillar 2A capital requirements in light of both the calculations included in a firm's ICAAP and the results of the PRA's own Pillar 2A methodologies. <u>In considering the level of capital that is necessary to capture risks to which the firm is or might be exposed, the PRA also takes into account the extent to which those risks are mitigated by macroprudential buffers.</u> Setting a Pillar 2A capital requirement is subject to peer group reviews to ensure consistency of decisions across firms.