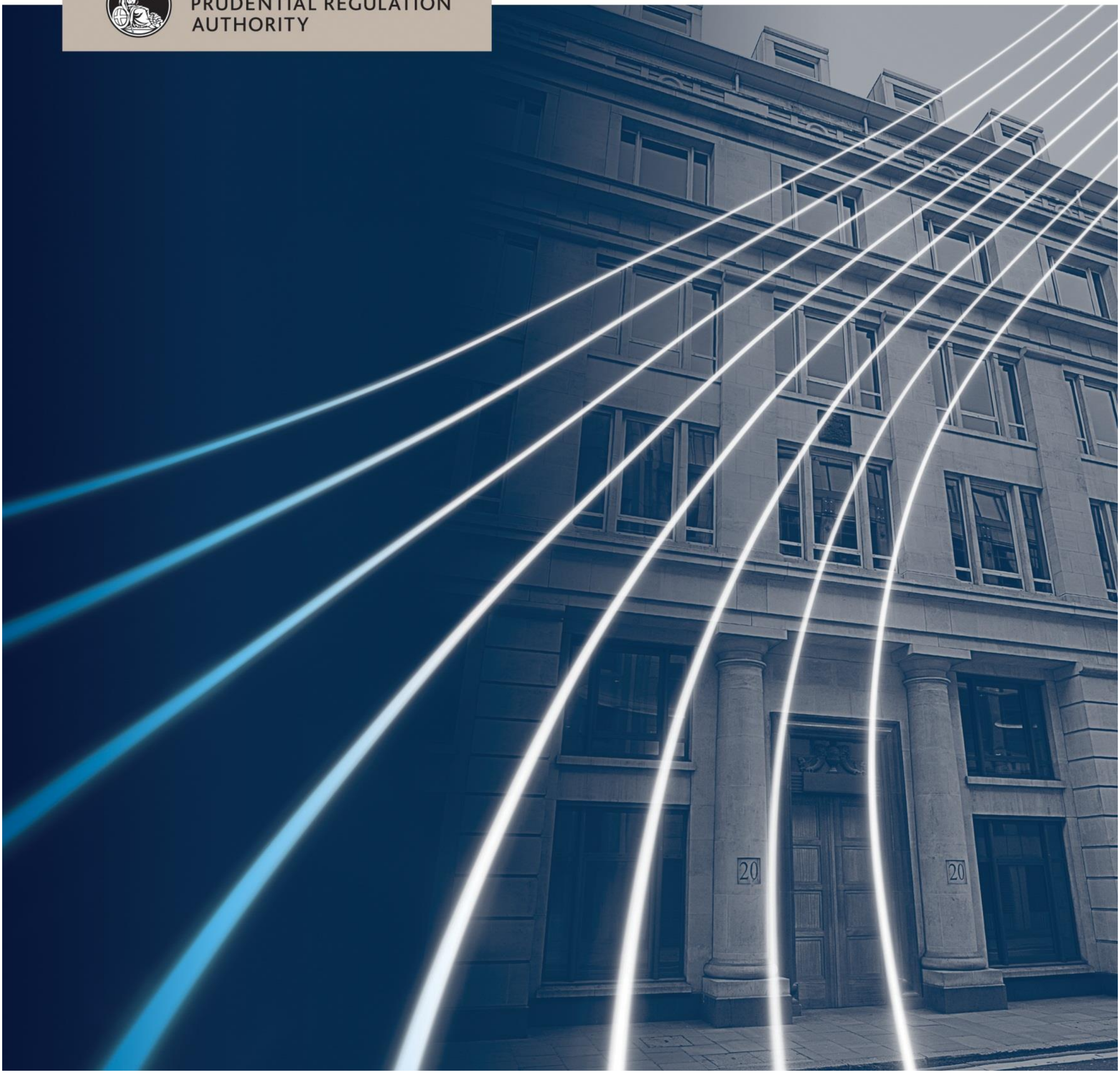
Policy Statement | PS22/17

Refining the PRA's Pillar 2A capital framework

October 2017

BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY



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Contents

1 Overview

1.1 This Prudential Regulation Authority (PRA) policy statement (PS) provides feedback to responses to Consultation Paper (CP) 3/17 'Refining the PRA's Pillar 2A capital framework'.[1]

1.2 It contains the final amendment to the Reporting Pillar 2 Part of the PRA Rulebook (Appendix 1) and updates to the following supervisory statements (SS) and statement of policy:

- SS31/15 'The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)' (Appendix 2);
- SS32/15 'Pillar 2 reporting, including instructions for completing data items FSA071 to FSA082' (Appendix 3); and
- Statement of Policy 'The PRA's methodologies for setting Pillar 2 capital' (Appendix 4).

1.3 It is relevant to banks, building societies and PRA-designated investment firms.

1.4 In CP3/17, the PRA made proposals in three areas:

(i) adjustments to the PRA's Pillar 2A approach for firms using the standardised approach (SA) for credit risk;

(ii) revisions to the PRA's internal ratings-based (IRB) benchmark used for assessing credit risk; and

(iii) additional considerations the PRA will make, as part of the SREP, for SA firms using International Financial Reporting Standard (IFRS) as their accounting framework.

1.5 Following consideration of respondents' comments, the PRA has made a few minor changes to the draft updates to the statement of policy contained in Appendix 1 of CP3/17. These include an update to the proposed risk weight used for personal loans as part of the IRB benchmark and a change to clarify the treatment of commercial real estate (CRE) exposures. These changes are explained in Chapter 2. The PRA does not consider these changes significant enough to have any additional material impact on firms, and so has not provided an updated cost-benefit analysis. The PRA has assessed the impact of its proposals on mutuals. It does not expect the effect of these proposals on mutuals to be significantly different to the effect on other firms.

1.6 No comments were received from firms on the rules required to give effect to the proposals. The final rules instrument in Appendix 1 therefore reflects the draft included in the consultation, with one minor amendment to insert a definition of the term 'data item' into the Reporting Pillar 2 Part of the PRA Rulebook.

1 CP3/17 'Refining the PRA's Pillar 2A capital framework', February 2017; www.bankofengland.co.uk/pra/Pages/publications/cp/2017/cp317.aspx.

2 Feedback to responses

2.1 The PRA is required by the Financial Services and Markets Act 2000 (FSMA) to have regard to any representations made to it, and to publish an account in general terms, of those representations and its response to them.[1]

2.2 The PRA received 16 responses to CP3/17. Most respondents were supportive of the proposals.

2.3 A number of respondents sought greater clarity on aspects of the proposals and their implementation. Specific areas where the PRA has amended or clarified the proposals are set out in this chapter.

Adjustments to the PRA's Pillar 2A approach for firms using the standardised approach (SA) for credit risk

2.4 In CP3/17, the PRA proposed to exercise its supervisory judgement to adjust variable Pillar 2A add-ons for firms using the SA for credit risk. Its judgement would be informed, alongside other factors, by a comparison of firms' SA Pillar 1 capital charges to the upper range risk weights of the IRB benchmark.

Legal compliance

2.5 One respondent challenged this proposal as they considered it would contravene Capital Requirements Directive (2013/36/EU) (CRD) by overriding the Pillar 1 regime.

2.6 The PRA considers that the proposal is consistent with its legal obligations under CRD Article 97 and no change in the proposed approach is necessary. The PRA will continue to undertake a risk-by-risk assessment using the PRA's Pillar 2A methodologies. It will then consider (taking into account the nature, scale and complexity of the firm; the principle of proportionality and the conservatism that may apply to certain portfolios under the SA) whether total own funds assessed on a risk-by-risk basis are sufficient or exceed the amount necessary to ensure a sound management and coverage of risk. CRD IV does not prohibit adjusting the appropriate level of Pillar 2A capital where it is in excess of that needed to achieve the aims set out in CRD Article 97. In addition, the proposals will not affect the setting of Pillar 1.

Pillar 2A scope of adjustments

2.7 A number of respondents suggested broadening the scope of the proposed adjustments to maximise their impact on capital requirements. They argued that the PRA should use average IRB benchmark risk weights, rather than the upper range, to inform its judgement on the conservatism that may apply to certain asset classes under the SA. They also requested further detail on the role of supervisory discretion. They questioned whether firms' risk management and governance (RM&G) should be taken into consideration when adjusting Pillar 2A as it already informs the PRA buffer via the setting of a scalar. Some respondents suggested that fixed Pillar 2A add-ons could also be adjusted.

2.8 The PRA has considered these points. While the suggestions would likely increase the capital impact of the proposals in CP3/17, they could undermine the safety and soundness of individual firms. For this reason, the PRA is not changing its proposals.

1 Section 2L..

2.9 The IRB benchmark provides an estimated range of the underlying credit risk in each asset class. Unless a firm has developed IRB models the PRA cannot gauge where on the range its credit risk lies, thus using the upper range ensures a more prudent application of the benchmark. This does not mean that firms seeking to obtain IRB permission should consider the upper range of the benchmark as an appropriate margin of conservatism to calibrate their internal models. For further information on the PRA's expectations to obtain IRB permission, readers should refer to SS11/13.[1]

2.10 Furthermore, the assessment as to whether a firm is adequately capitalised is not mechanistic but based on supervisory judgement. It will depend on whether the benchmark – which is based on broad asset sub-classes – is representative of firm-specific risk profiles. Supervisory judgement will therefore continue to be central to the setting of Pillar 2A capital. The PRA will not adjust variable Pillar 2A add-ons downwards where a firm has poor RM&G. There is no overlap with RM&G scalars which are set to cover additional losses that may arise under a severe stress scenario due to significant RM&G weaknesses. The PRA also considers that the fixed elements of Pillar 2A should not be adjusted as it is important to ensure that capital remains available to meet claims arising from pension obligations.

2.11 Two respondents asked that the adjustments to Pillar 2A add-ons be applied to firms using the SA for some parts of their book, and for other parts the IRB approach. As noted in CP3/17, the adjustments could also apply, on a case-by-case basis, to those portfolios that are subject to the SA at firms employing IRB models for other portfolios. However in considering applying the refined approach to those specific portfolios, the PRA will assess whether the IRB benchmark would provide an accurate representation of the risk of the portfolios.

Use of internal models

2.12 Three respondents requested that the PRA should make greater use of SA firms' internal models when adjusting capital requirements.

2.13 Internal model outputs, alongside any other relevant information, should be submitted to the PRA as part of the ICAAP, in line with SS31/15. The ICAAP is taken into consideration as part of the PRA's overall assessment of the level of capital that would be sufficient to ensure a sound management and coverage of firms' risks. This assessment then informs potential adjustments that can be made to variable Pillar 2A add-ons.

2.14 Internal models, unless approved by the PRA, cannot be used to set Pillar 1 requirements. As noted in paragraph 2.9 firms seeking to obtain IRB permission should refer to SS11/13 which includes updates to clarify the PRA's expectations on the IRB approval process.[2]

Revisions to the IRB benchmark

2.15 In CP3/17, the PRA proposed to update its IRB benchmark. This benchmark will be used to inform whether additional capital is required under Pillar 2A for credit risk and whether any adjustments need to be made to variable Pillar 2A add-ons.

1 'Internal Ratings Based (IRB) approach', October 2017, www.bankofengland.co.uk/pra/Pages/publications/ss/2017/ss1113update2.aspx.

2 PS23/17 'Internal Ratings Based (IRB) approach: clarifying PRA expectations', October 2017: www.bankofengland.co.uk/pra/Pages/publications/ps/2017/ps2317.aspx sets out the final policy and feedback to consultation responses following CP5/17 'Internal Ratings Based (IRB) approach: clarifying PRA expectations', March 2017: www.bankofengland.co.uk/pra/Pages/publications/cp/2017/cp517.aspx.

Transparency

2.16 Five respondents asked for greater transparency on the methodology used to calculate the IRB benchmark and details on IRB firms' modelling approaches (eg underlying probability of default, loss given default and risk weight distribution). They argued this would help firms using the SA to develop internal models. Respondents also asked for a more granular breakdown of the benchmark with risk weights split by debt to income ratio.

2.17 The PRA is reluctant to provide more information on the IRB benchmark's underlying parameters. The provision of these extra data could undermine the IRB model development and approval process, as firms should develop internal models based on their own lending practices and experience and using sound modelling practices. The PRA is not proposing to provide a more granular breakdown of the IRB risk weights within each asset class as this would lower the data sample size further.

Commercial real estate exposures

2.18 Eight respondents were unclear on the proposed change in the application of the IRB benchmark for CRE exposures. Noting that the range of risk weights in the IRB benchmark for CRE exposures is wider than for other classes, respondents raised concerns that the PRA was proposing to use the upper range of the IRB benchmark as a floor when assessing the degree of conservatism of the SA for CRE portfolios.

2.19 In CP3/17, the PRA proposed to encourage SA firms with material CRE exposures to assign these, as part of their ICAAP, to the risk weight category for specialised lending exposures in accordance with the European Banking Authority's draft technical standards on specialised lending exposures.[1] The PRA considers the slotting approach[2] to be more appropriate than using average IRB risk weights for the purpose of assessing potential conservatism in the SA. This is because evidence indicates that IRB firms' CRE exposures differ significantly from SA firms' portfolios.

2.20 The PRA's assessment of the degree of conservatism of Pillar 1 SA risks weights for CRE will be informed by the outcome of the firms' assessment of exposures under the slotting approach and the quality of that assessment. SA firms are not obliged to use this framework. If they deem their CRE portfolios to be immaterial or if they are unable to produce the assessment, the PRA will apply an appropriate and prudent alternative risk weight; this would default to the upper range of the benchmark outlined in CP3/17. The risk weights set out in CP3/17 cover the full regulatory range to which firms' CRE portfolios could vary under the slotting approach. The PRA has amended the IRB benchmark, which is contained in the Pillar 2 Statement of Policy (Tables A1 and A2 in Appendix 4), to clarify this point.

2.21 A number of respondents also asked for clarification on the definitions of CRE development, CRE investment and residential development exposures. The terms CRE development and CRE investment are already defined in Appendix 1 to SS32/15.[3] For the purposes of the benchmark assessment, residential development exposures are considered to be part of CRE development portfolios.

1 www.eba.europa.eu/-/eba-publishes-final-draft-technical-standards-on-specialised-lending-exposures.
2 See Articles 153(5) and 158(6) of the Capital Requirements Regulation (575/2013) (CRR).
3 Guidance on Terms used in data items FSA071 to FSA082: www.bankofengland.co.uk/pra/Documents/crdiv/guidanceontermsusedindataitemsfsa071tofsa082.pdf.

Credit risk methodology

2.22 Some respondents interpreted the proposed update to the IRB benchmark as a change to the PRA's Pillar 2A credit risk methodology. One respondent asked whether the increase in IRB risk weights for certain portfolios could lead to higher Pillar 2A credit risk add-ons.

2.23 The PRA is not proposing any change to its Pillar 2A credit risk methodology. In line with its current approach, the PRA will assess whether the IRB benchmark implies that the SA underestimates the overall level of capital necessary to cover credit risk on an aggregate basis. Supervisory judgment is then used to determine the Pillar 2A credit risk add-on. While the updated IRB benchmark could result in higher Pillar 2A credit risk add-ons for some firms, the PRA does not expect any material increase.

Cyclicality

2.24 One respondent queried whether the IRB benchmark, and any future updates, could transmit the potential cyclicality of IRB risk weights to SA firms. Concerns were also raised on the lag between the sample period used to calculate the IRB benchmark and its application to SA firms.

2.25 As noted in CP3/17, the PRA will monitor changes in IRB risk weights on a regular basis. Where significant movements are observed, the PRA will consider updating the IRB benchmark. This ensures the benchmark risk weights accurately reflect the underlying credit risk to which firms are exposed. Updates should also minimise the lag between the data used to calculate the benchmark and its application to firms. That said, the PRA acknowledges that frequent updates may transmit variations in IRB risk weights through to SA firms' Pillar 2A add-ons. Excess variability in capital requirements could be detrimental to financial stability. The PRA will carefully consider this risk when updating the IRB benchmark. In addition, the PRA made amendments to SS11/13 in June 2017, to expect firms to change the calculation of IRB risk weights for residential mortgages to address their high level of variability over the cycle. These changes are due to be implemented by the end of 2020 and should further limit the risk of excessively cyclical capital requirements in the medium term.

Additional considerations, as part of the SREP, for SA firms using IFRS as their accounting framework

2.26 In CP3/17, the PRA proposed to introduce a separate IRB benchmark for firms using the SA for credit risk and IFRS as their accounting framework. This benchmark would be based on unexpected losses only, by removing expected losses (EL) from the calculation of IRB risk weights. It will inform the setting of Pillar 2A in light of the potential overlap between IFRS 9 provisions and the SA risk weights which may already reflect EL to an extent.

2.27 The PRA has corrected an error in the IRB benchmark excluding EL for personal loans. The benchmark published in CP3/17 included EL for these portfolios. The revised IRB risk weights range from 65.9% to 89.2% with an average risk weight of 77.5%.[1] The PRA does not expect these corrections to have any material impact on firms.

Scope of application

2.28 Three respondents asked that the IRB benchmark excluding EL be applied to all firms, including firms using the SA for some portfolios, to take into account the increase in provisions due to IFRS 9.

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1 Shown in the updated Statement of Policy 'The PRA's methodologies for setting Pillar 2 capital': www.bankofengland.co.uk/pra/Pages/publications/sop/2017/p2methodologiesupdate2.aspx.

2.29 The PRA aims to address the double count of EL that may arise between the SA Pillar 1 capital charge and IFRS 9 provisions for all firms applying the SA, including IRB firms with portfolios on the SA. It will apply the IRB benchmark excluding EL for all firms with SA portfolios, both as part of the Pillar 2A credit risk methodology and the Pillar 2A refined approach.

2.30 As noted in CP3/17, should the impact of IFRS 9 on capital be subject to transitional arrangements, the PRA will take that into consideration when estimating the double count of EL (see further paragraphs 2.33 and 2.34 below) to ensure accuracy of the estimate.

2.31 The Financial Policy Committee (FPC) announced in March 2017 that it will review the optimal level of capital requirements in the UK banking system in light of the outcome of ongoing negotiations to finalise Basel III standards and the implementation of IFRS 9. The PRA will consider the conclusions of this review and monitor the impact of IFRS 9. If appropriate, it may consider further refinements to its Pillar 2A policy.

Implementation

Timeline

2.32 As proposed in CP3/17, the refined Pillar 2A capital framework will come into force on 1 January 2018. The PRA will implement the new approach as part of the SREP reviews. To support the assessment, firms are required to submit the Pillar 2 data items FSA076 and FSA077 alongside their ICAAP. In line with SS31/15, the PRA continues to expect firms to carry out an overall assessment of their risks as part of their ICAAP. This includes firms taking account of the higher degree of conservatism that may apply to certain asset classes under the SA compared to the IRB.

IFRS 9 transitional arrangements

2.33 Several respondents asked how the PRA would consider any internationally agreed transitional arrangements for IFRS 9 when applying the IRB benchmark excluding EL.

2.34 IFRS 9 transitional arrangements are still subject to negotiations at the European level. Subject to the transitional arrangements being agreed and put in place, the PRA will ensure prudent application of the IFRS 9 benchmark. The PRA will, in particular, ensure there is no material overlap or underlap between the capital relief provided by the IFRS 9 transitional arrangements and the adjustments to Pillar 2A capital add-ons under the refined approach.

Basel III finalisation and the UK regulatory framework

2.35 A number of respondents asked that changes be made to Pillar 1 rather than Pillar 2A to reduce differences in capital requirements between the standardised and IRB approaches. They argued that adjustments to Pillar 2A would have a limited impact as regards facilitating competition in the banking sector as they would not be reflected in published capital ratios. Respondents also requested changes to the rest of the capital framework, including to capital buffers and minimum requirements for own funds and eligible liabilities. Furthermore, concerns were raised about the interaction between the Basel Committee on Banking Supervision's (BCBS) proposed revisions to the standardised and IRB approaches to credit risk, including the proposed output floor, and the refined Pillar 2A capital framework. One respondent suggested that the refined Pillar 2A framework should be used to provide temporary, rather than permanent capital relief to SA banks until the BCBS's revisions are finalised and implemented.

2.36 As noted in CP3/17, the PRA expects that, subject to agreement and implementation, the BCBS's revisions to the standardised and IRB approaches will lead to smaller differences in capital requirements between the two approaches. This would imply that the size of the proposed adjustments to Pillar 2A add-ons would become smaller over time. In terms of disclosure, in addition the PRA has published proposals that include an expectation that firms would disclose Pillar 2A capital requirements (see CP12/17[1]). These proposals would ensure that Pillar 2A adjustments are taken into account by market participants.

1 'Pillar 2A capital requirements and disclosure', July 2017: www.bankofengland.co.uk/pra/Pages/publications/cp/2017/cp1217.aspx.

Appendices

1	**PRA Rulebook CRR Firms: Reporting Pillar 2 Instrument (PRA 2017/32) available at www.bankofengland.co.uk/pra/Pages/publications/ps/2017/ps2217.aspx**
2	**Supervisory Statement 31/15 UPDATE 'The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)' available at www.bankofengland.co.uk/pra/Pages/publications/ss/2017/ss3115update2.aspx**
3	**Supervisory Statement 32/15 UPDATE 'Pillar 2 reporting including instructions for completing data items FSA071 to FSA082' available at www.bankofengland.co.uk/pra/Pages/publications/ss/2017/ss3215update.aspx**
4	**Statement of Policy UPDATE 'The PRA's methodologies for setting Pillar 2 capital' available at www.bankofengland.co.uk/pra/Pages/publications/sop/2017/p2methodologiesupdate2.aspx**