UK FINANCE

A response to the

The PRA's CP16/22

Chapter 10

Pillar 2

March 2023

Introduction

UK Finance is the collective voice for the banking and finance industry. Representing more than 250 firms, we act to enhance competitiveness, support customers, and facilitate innovation.

We are pleased to respond to chapter 10 of the PRA's CP16/22 which reviews the interaction between the PRA's approach to implementing the finalised Basel 3 standards ('Basel 3.1') and its Pillar 2 regime.

Proposed future review of the PRA's Pillar 2 framework

Recommendation 10.1

- The Pillar 2 framework review should be completed as swiftly as possible.

Rationale

We welcome the PRA's intention to review its Pillar 2A methodologies more fully by 2024, so that necessary Pillar 2 and associated reporting changes can be made before the introduction of the new Pillar 1 framework. Given that firms plan their capital over a multi-year horizon we look forward to contributing to these discussions and the finalisation of the PRA's revised Pillar 2 framework in the near future. An important outcome of the revised Statement of Policy will be greater transparency of how Pillar 2A and the PRA Buffer are set. This will benefit both firms themselves and their investors.

Impact of Basel 3.1 ON Pillar 2

Recommendation 10.2

- PRA should provide more granular detail about in which P2 categories offsetting capital reductions to offset Pillar 1 increases will be made.

Recommendation 10.3

- Double counting in capital requirements between Pillar 1 and Pillar 2 must be avoided.

Recommendation 10.4

- The PRA should amend the derivation of MREL requirements to be the higher of:
    - *(2 x (P1 + P2A) + RWA Buffers) x RWAs or;*
    - *(6.5% + Leverage Buffers) x Leverage Exposure*

Rationale

The PRA has indicted that it expects that the impact of the introduction of Basel 3.1 package will lead to an across the system increase in Pillar 1 RWAs of 13%, but that Pillar 2 reductions will offset this impact restricting the increase to less than 5%.

We note that the Financial Policy Committee have previously indicated that the amount of capital in the system was already appropriate (Dec'15 FSR). It is easy to dismiss the impact of Basel 3.1 as "only c.5%", but there are a number of changes that already impact the regulatory capital system, including but not limited to implementation of the IRB roadmap and IFRS9 accounting provisions, which have similarly increased the amount of capital firms are required to hold for the same risk (noting the recent CP6/23 proposal to reverse the NPE adjustment).

We encourage the PRA to ensure their review of Pillar 2 is sufficiently holistic and does not simply cover the removal of obvious mechanical double-counts (e.g. Pillar 2A offset to Pillar 1 Operational Risk increases, or PRA buffer methodology filtering out the impacts of regulatory change that happen during the stress test modelling period) but also the appropriate calibration of all regulatory buffers given the new Pillar 1 calculation.

The review of Pillar2 should aim to neutralise the impact of the Basel 3.1 Pillar 1 and other regulatory changes across the UK financial system, not only at the Total Capital level or Tier 1 level, but for each individual Tier of capital (CET1, T1, TC and MREL)

Whilst we can see a possible reduction from the operational risk element, other reductions are difficult to identify and indeed in some parts of the Pillar 2 framework, such as credit risk, we may actually see an increase in Pillar 2 as this amplifies the Pillar 1 framework. where increases are expected. Any double counts in capital requirements between Pillar 1 and Pillar 2 must be avoided.

Similarly, amplification effects would be observed in the form of nominal capital requirements due to the buffers (G-SII, O-SII, CCoB, CCyB and any applicable PRA buffer), where a static % buffer is a direct function of increasing P1 RWAs, if no associated mitigating intervention is introduced. Where firms are not currently subject to a non-zero PRA buffer, there may be challenges to effecting associated mitigants directly through the buffers (i.e. conservation buffer is static at 2.5%, and Countercyclical buffer is not set by PRA). However, precedent for such mitigation was positively observed with the introduction of the 2.0% UK CCyB rate, where adjustments were made to neutralise the marginal impact to capital requirements via the introduction of a P2A CCyB offset.

In the context of MREL, for firms constrained by leverage (i.e. 6.5% x Leverage exposure > 2 x [P1 + P2A] x RWA), the increase in P1 RWAs will likely see an unmitigated increase in Total MREL requirements, if not due to RWAs becoming the constraining metric for the first part of the requirement, then as a consequence of the inflation in RWA related buffers which we presume will be relatively unimpacted by P2 mitigants, and most often exceed leverage buffers in nominal terms (due to omission of the conservation buffer for leverage). At present, the determination takes the max(2x(P1+P2A)xRWA,6.5xLevex) + max(RWA buffers, Leverage buffers) which can lead to one part being driven by Leverage and another by RWAs, with the potential co-mingling of the 2 abstract perspectives to generate an overall MREL requirement feeling contrary to the intended independence of each standalone framework.

Capital Planning

Recommendation 10.5

- The PRA should provide guidance on how Pillar 2 changes should be incorporated into capital planning before the outcome of the Pillar 2 review are known.

Rationale

Pillar 2 elements form an important part of capital planning, which already covers the period beyond the implementation of Basel 3.1. We would welcome guidance on how changes to Pillar 2 should be reflected in the capital planning ahead of the review of Pillar 2 planned for 2024. For example, for stress testing purposes, we assume that there should not be a *supervisory* need to hold excess capital arising from regulatory change impacts in the form of stress buffers in advance of the implementation of Basel 3.1 in the UK, in respect to prospective reductions in capital headroom as a consequence of Basel 3.1 in the forecast horizon. This would simply act as an effective acceleration of the implementation date, albeit the requirements manifesting in buffer requirements as opposed to P1.

As we note below firms would also like to understand how transitional Output Floor provisions (as well as our suggestion for the phasing out of the SME supporting factor) will impact Pillar 2 elements of a firm's capital plan. Similarly at the 1st January 2025 implementation date, should the transitional provisions be taken into consideration in stress test projections, or should the end state be used as a T0 starting point adjustment?

If the transitional rules 'bite,' step changes in RWAs will be observed in stress test projections, leading to deterioration in capital headroom and in theory resulting in 'accelerated' stress capital buffers ahead of the transitional timelines, effectively negating the intended benefits of the transitional purpose.

This issue is related to the timing point above (and also covered later), as during the transition period there are step changes which could result in materially different Pillar 2 requirements between the end of December in one year and the first day January of the following year (both in terms of prevailing effective P2 requirements and analysis of projected P2 requirements), despite there being no changes in the underlying risk.

Credit risk (SA vs IRB) - benchmarks

Recommendation 10.6

- The PRA should consider the removal of the SA vs IRB assessment given convergence in risk sensitivity between the two approaches. If the assessment is retained, the stated IRB benchmarks should be recalibrated.

Rationale

Following the changes to both IRB and standardised approaches some firms wonder if there is a continued requirement to assess credit risk (SA vs IRB) in Pillar 2a at all. Whilst noting the PRA '*considers a Pillar 2A methodology for credit risk would likely continue to be required.',* does the move to a more risk sensitive SA approach and thus convergence to IRB not negate the P2 focus?

To the extent the assessment is deemed still required, it would also be helpful to understand when IRB benchmarks will be refreshed and published in the Statement of Policy to help SA firms assess their Pillar 2 requirements.

Credit Risk (SA vs IRB) - Sovereign exposures

Recommendation 10.7

- The PRA should give clearer guidance about the intended treatment of UK sovereign exposures.
- The PRA should update the leverage framework to exclude UK sovereign bonds from contributing to the reported leverage exposure and related O-SII assessments.

Rationale

We would welcome more explicit and transparent clarification on the PRAs own treatment of UK sovereign exposures within the context of the Credit Risk SA vs IRB P2 assessment. Whilst a number of firms may currently report £0 RWAs for these positions (either due to SA or permanent partial waivers), this 'beneficial' treatment is viewed to be aligned to broader Bank of England objectives given these HQLAs are predominantly held for prudential liquidity purposes and support the wider UK economy/government funding. It is thus desirable for firms to clearly understand the PRAs own perception of risks associated with UK sovereign exposures, and thus any additional capital which the PRA may attribute to such exposures in this context.

Credit Concentration risk

Recommendation 10.8

- The HHI should be recalibrated, and if retained updated to adopt a non-midpoint approach to % scalars (to remove cliff edge effects between buckets).

Rationale

The HHI calculation is generic and particularly penal for UK focused residential mortgage lenders which will be subject to penal concentration risk add-ons as a result of the application of the HHI. As already observed with the IRB roadmap changes in 2022 (e.g. UK retail mortgage model transition to a PiT/TTC hybrid model), inflation in associated RWAs flow through into the relevant SNC, Sector and Geographic assessments (noting retail mortgages themselves only flow into geographic). This leads to higher HHI % add-ons (either due to transition of buckets or utilisation of non-midpoint %). These are further amplified by applying the increased % to higher RWAs, with resulting increases in nominal P2a and P1 capital requirements.

This will then feed through into higher stress hurdle rate requirements as the concentration risk is linked to credit RWAs in an ACS scenario (and internal stress scenarios), thus amplifying the PRA stress buffer outcomes.

Given the material increases in risk weights through recent changes to IRB methodology, hybrid modelling, the introduction of the output floor and leverage requirements for larger firms the concentration risk element of Pillar 2 should either be removed or HHI bucket % reviewed and recalibrated to reduce this amplification effect.

We do note in the instance of the prior mortgage model change, the reduced risk sensitivity would translate to reduced 'gross' stressed buffers (lower RWA stress inflation), albeit the scope of this benefit is limited to the existence of firm specific PRA buffers as other buffers are unrelated to firms' stress assessments. In a related context, beyond situations where either input floors (or output floor) bite, we do not anticipate similar B3.1 'reduced sensitivity' benefits flowing through for stress projections to negate the impact to the overall capital footprint.

Traded Market Risk

Recommendation 10.9

- Clarity on PRA approach to isolate and thus eliminate overlap between P1 and P2a for 'illiquids'.

Rationale

As highlighted in the CP, the B3.1 guidelines will extend the liquidity horizon beyond 10-days for illiquids and specified other exposures for P1 market risk RWAs. For the associated P2a assessment (illiquids, concentrated and one-way risk exposures) an assessment of additional capital is required to reflect the challenges of liquidating such positions within the specified P1 timeframe. However, such assessments effectively double count the capital for the initial P1 liquidity horizon. Whilst an offset could be derived to 'eliminate' the relevant exposures contribution to P1 and thus remove the double count, given the portfolio nature of the P1 assessment, the determination of independent marginal contribution to the P1 charge for such positions is not without its limitations.

Timing

Recommendation 10.10

- Firms should be able to apply adjusted Pillar 2 requirements as soon as the Basel 3.1 framework is applied.

Rationale

There is a concern that the inherent lag in ICAAP and SREP cycles may result in a delay to any stated reductions in the Pillar 2 requirements being formally applicable until after the implementation of the Pillar 1 changes. For example, the SREP issued in H2 2024 will be based on the ICAAP data submitted in H1 2024 (based on Dec'23 balance sheet). This determines the Pillar 2 requirements that are to be used from H2 2024, to H1 2025. With a change in Pillar 1 requirements from 1 January 2025, we would welcome the ability to apply adjusted Pillar 2 requirements from the point at which changes to the Pillar 1 framework are implemented, to avoid unintentional inflation in nominal capital requirements, albeit acknowledging this would be in theory a temporary timing issue. This is equally relevant for both P2A and prevailing PRA buffers.

Furthermore, any SREP outcomes (P2A and PRA buffer) in relation to the Dec 2024 balance sheet should be anchored to a firm's 1 January 2025 Pillar 1 RWAs, not those at 31 December 2024.

Similarly, where/when firms anticipate the output floor transition 'bite' similar allowances to bifurcate the effective P2A and PRA buffers should be made to avoid artificial inflation in P2 capital requirements.

Simplified Pillar 2 approach

Recommendation 10.11

- Smaller firms should not need to prepare a full ICAAP every year.

Rationale

Smaller firms which have a less frequent SREP cycle do not represent a significant systematic risk to the UK financial system. Partly in recognition of this the PRA typically only undertakes a C-SREP/L-SREP every 3 years. We therefore question if it is necessary to prepare a full ICAAP on an annual basis, which can be costly. The PRA should seize the opportunity to reduce the regulatory burden on small firms to a level more appropriate to the level of risk they represent to the UK financial system.

Firms and their boards will still wish to stress their capital capacity annually, but smaller firms are able to do so without preparing a full ICAAP each year as their simplicity allows changes impacting stress capital capacity to be immediately understood and managed.

We suggest that the full ICAAP should be limited to C-SREP years, with sufficient pre-warning to prepare the full documentation. This could be supplemented in interim years by a simpler alternative designed to monitor material changes in structure, business model and capital requirements.

Interaction with the Output Floor

Recommendation 10.12

- The PRA should ensure that capital increases arising solely from the interaction between the output floor and Pillar 2 are avoided.

Rationale

We are concerned that the application of the output floor and its interaction with Pillar 2 will increase capital requirements even when risk remains static, as this example shows.

If a firm's breakdown of the 'Individual Capital Requirement' for Pillar 2A risks prescribed by the PRA totals £100 and the total RWA (before implementing the OF) was £1,000, the P2A requirement as percentage of RWA prescribed to a firm would be 10%.

After receiving this P2A requirement percentage, the firm's Total RWA later increases to £1,200, driven entirely by the implementation of output floor.

The amount of capital this firm would have to hold for Pillar 2A risks increases from £100 (as assessed prior to the implementation of the output floor) to £120 (new RWA of £1,200 x P2A requirement of 10%).

Without recalibration of the Pillar 2A percentage requirement for this firm for the period when the output floor becomes binding, the firm would need to hold an additional £20 of capital for the same Pillar 2A risks, even if there is no actual increase to the risks contributing to firm's £100 Pillar 2A requirement from the SREP prior to the OF becoming binding.

Similarly, given the differences between the Advanced IRB and SA, where the output floor is observed to bite, specific consideration of a P2 offset for Advanced vs SA shortfall should be made to avoid diminishing the quality of the P2 assessments and acknowledging the P1 uplift due to output floor can also be considered in scope to address 'inadequacies' in P1 advanced approaches.

Consideration is also required of the relationship/driver of the P2A projections as part of the stress hurdle rate (P2 Statement of policy para 9.21 – 9.23) in situations where the output floor bites. This may require clear guidance on how an output floor driven RWA is decomposed into dedicated risk type RWAs (e.g. Credit, CCR, Market, Operational) for this purpose.

Ongoing discussions

We look forward to building on our ongoing discussions with the PRA Pillar 2 team so that we can fully explore together the ramifications of this regulatory change. The introduction of Basel

3.1 does not, of itself, increase risk but does, mechanistically flow through into the amount of additional Pillar 1 and Pillar 2 capital firms hold against the risks they take and as a result of stress testing if no explicit mitigating action is taken (e.g. P2 offsets, bifurcation of SREPs, MREL).

Responsible executives

✉ simon.hills@ukfinance.org.uk
☎ +44 (0) 7921 498183

✉ nala.worsfold@ukfinance.org.uk
☎ +44 (0) 7384 212633