UK FINANCE

A response to PRA consultation CP 17/20

CRD V: Further implementation

November 2020

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 the consultation on CRD V Further implementation. We very much support the proposed approach to the implementation of prudential regulation. In this response we respond to the three specific questions in the consultation as well as a few other areas where our members have some concerns or would like clarification. These points are covered below in chapter order in the consultation as follows:

- Holding companies (chapter 2)
- Interest rate risk in the banking book (chapter 4)
- Maximum Distributable Amount (chapter 6)
- Variable risk weights for real estate exposures (chapter 9)
- Other – implementation of CRR2

Holding companies

We generally support the proposal to require approval of holding companies, the flexibility for exemption provided certain criteria are met and consider this to be a pragmatic and proportional approach. However, the registration proposals for Holding companies appears unduly complex and would benefit from simplification. We are aware that the PRA already has an existing level of oversight over the activities of holding companies and therefore would suggest that a system of automatic designation is implemented to achieve the objective of Art 21a. This would give certainty to applicant firms and allow them to consider any potential changes once the approach to supervision is clearer. The option to apply for an exemption from automatic designation should still be retained.

The challenge for firms is that there is little detail in the consultation paper on the shape of day-to-day compliance for holding companies once authorisation is granted or holding company specific framework or structures needed to support the process of ongoing supervision. As an alternative we feel that an application process where the applicant confirms that the necessary frameworks are in place to support effective supervision with a commitment to updating them once details of the ongoing supervisory regime are known could be used. Given the lack of information currently on ongoing supervision there is a significant risk that any application for authorisation would need substantial reworking after submission with significant cost and time implications for both the PRA and applicant firms.

Most firms will need to begin a significant process of internal consultation and governance in order to apply and this will take a significant amount of time and resources. In that context we feel that the costs in terms of time and budget would be significantly higher than those projected in CP17/20.

We believe this more flexible and pragmatic approach can achieve all our objectives, recognising that firms are already supervised on a consolidated basis and remove the uncertainly around the approach to ongoing supervision. Arguably, the work associated with any application is a distraction from the focus we have on customers, the recovery and normalisation in practices arising from Covid-19 and our support to the economic recovery. In this regard, if the PRA were able to adopt a more flexible approach, we would suggest that firms had a longer time to implement any changes required, probably a minimum of 12 months.

Interest rate risk in the banking book

Question 1: Is the proposed approach to implementing the BCBS standards through a combination of PRA rules and supervisory expectations sufficiently clear and proportionate?

We generally support the proposed approach for IRRBB outlined in the consultation paper. While the proposal is largely clear and proportionate there are a few areas below where our members would like further clarity:

1. Implementation requirements
2. Compliance with EBA and BCBS IRRBB regulation
3. Proposed implementation date and level playing field
4. The specification of the supervisory outlier test
5. Treatment of FSA017
6. Proportionality

1. Implementation requirements

We would like to confirm our interpretation of the parts of the proposed wording in the consultation paper that are binding PRA rules and the parts that are supervisory expectations. Additionally, we are seeking further clarity on the level of application and interim disclosure requirements.

Binding rules versus Supervisory expectation

In Section 4.9 of the consultation paper it specifies that “the status of the applicable IRRBB requirements would change from an EBA GLs requirement, with which firms must make every effort to comply, to binding PRA rules or supervisory expectations”. Given this change in stance, we would

like to ensure our interpretation is correct as, while the proposed wording in SS31/15 has significant overlaps with the EBA guidelines, there are a number of incremental requirements that are likely to take more time to implement than the currently proposed timelines. For example, Section 2.9Bi) proposes a three to five year earnings metric, which is not required in the EBA guidelines, that is likely to take significant time and effort for firms to implement. As such, a clear understanding of the requirements is needed to ensure that firms do not inadvertently breach any binding PRA rules.
Our understanding is:

- the proposed ICAA wording, as specified in Appendix 2, are binding PRA rules that members must comply with at the implementation date.
- The proposed amendments to SS31/15, as specified in Appendix 3, are supervisory expectations. Further to this, some members may not fully comply with these supervisory expectations at the time of implementation and in these cases the member should share a plan for compliance with their supervisor and provide details in their ICAAP. This will not, however, be treated as a breach of a binding PRA rule.

Level of application

We would welcome clarity on the level of application of the proposals. We note that the BCBS standards are intended to apply to 'large internationally active banks on a consolidated basis'. Nevertheless, national competent authorities might choose to apply the BCBS framework more widely at different level of consolidations, including on an entity basis. Clarification from the PRA on intended application level is needed, this is especially relevant as UK banking groups have implemented organisational structures to reflect the required ring-fencing regime. We recommend that the PRA take account of the Basel Committee's intentions and implement the proposals in a proportionate manner that correlates with the level of sophistication of firms.

Disclosures

We note that section 4.31 of the consultation paper specifies that the PRA intend to consult on its implementation of Basel III's new disclosure requirements for IRRBB in due course. Until such time as the PRA has completed its consultation and issued final requirements we presume that existing disclosure requirements remain in force.

2. Compliance with EBA and BCBS IRRBB regulation

We would like to understand how the proposed PRA implementation will interact with other IRRBB regulation.

EBA Guidelines

Currently, Chapter 9 of the PRA rule book specifies that members are required to comply with the EBA Guidelines. Our understanding is that this consultation paper proposes replacing the existing text in Chapter 9 of ICAA with the text detailed in Appendix 2. As such, we interpret this to mean that members will no longer need to comply with the EBA guidelines post these changes. If this is incorrect, there are a few inconsistencies between the EBA guidelines and the proposal in this consultation paper where further clarification is required.

BCBS 368

Section 4.5 of the consultation paper states that 'The PRA proposes not to implement CRD V's requirements on IRRBB and instead to implement the BCBS IRRBB standards directly into the PRA regulatory framework'. However, the proposed wording in section 5 of Appendix 2 and section 9 of Appendix 3 do not capture BCBS368 in its entirety and also contains clauses that are not specified

in the Basel standard. We interpret this to mean that the proposed implementation is limited to the consultation paper, including the appendices, and does not extend to the full BCBS368 Standard.

3. Proposed implementation date and level playing field

The timeline proposed in CP 17/20 by the PRA significantly accelerates the UK adoption of the BCBS IRRBB standards ahead of the EU. Although Basel IRRBB standards have been in force on a 'comply or explain' basis from 2019 through EBA Guidelines, requiring these standards be fully binding from 31st December 2020 risks putting UK firms at a disadvantage versus European peers. This approach ignores that the EBA GLs were published as a transitional guidance document and banks may have decided to wait for complete and final PRA guidance on CRDV transposition before fully adopting all IRRBB requirements. The industry is concerned that the accelerated PRA implementation timeline creates an uneven playing field with EU versus UK and request that an implementation period from the publication of final rules is mandated by the PRA.

Furthermore, the COVID-19 pandemic has also increased operational pressures on organisations, creating unforeseen and urgent competing priorities impacting firms' ability to dedicate resource to regulatory deliverables, including IRRBB. We would therefore welcome the PRA taking this into account when finalising a UK implementation date.

Based on the 12th June 2020 EBA letter to John Berrigan, the EBA IRRBB technical standards will be delayed until Q1/Q2 2022, which represents full IRRBB implementation in the EU, and the industry would recommend the PRA follow a similar timeline for full implementation of BCBS IRRBB standards in the UK.

To that end, and to align with the EU, we recommend an 18-month implementation period from the publication of the final rules. The EU is adopting a similar approach for IRRBB ITS disclosure requirements, as outlined in the EBA Risk Reduction Package Roadmap, and provides a 12-month implementation period from publication of the final ITS to when the first disclosures are required.

As an alternative, the industry requests that the PRA considers a phased implementation of the BCBS IRRBB standards in the UK, similar to the EU approach, beginning June 2021 through to full implementation by June 2022. This approach will allow the PRA time to clarify Day 1 minimum requirements versus future supervisory expectations, which the industry feels is unclear in the current PRA consultation. For example, paragraph 4.6 of the CP 17/20 suggests there will be distinction between minimum requirements and implementation expectations, but lacks specific detail. Also, the proposed PRA timeline suggests the new IRRBB ICAAP requirements would need to be satisfied in the next ICAAP submission which seems unreasonable given the extent of changes required in the timeframe versus current PRA ICAAP expectations. Aligning to the EU implementation timeline through a phased approach or otherwise will help address these concerns.

4. The Specification of the Supervisory Outlier Test (SOT)

Implementing the BCBS 368 version of the SOT poses some difficulty for firms given the standards deviate from the EBA guidelines that were previously being worked to, and the current internal risk modelling approach that some firms adopt. We would appreciate further clarity on a number of the requirements of the SoT and are concerned that the proposed implementation may lead to unintended consequences.

Specification of CET1 Capital rather than Tier 1 Capital

Our primary concern is the specification that the immediate review of firms IRRBB and management of IRRBB is triggered for a decline of more than 15% of CET1 capital, rather than 15% of Tier 1 capital, as in the BCBS368 and EBA Guidelines. Using CET1 capital instead of Tier 1 capital is tighter than the Basel and EBA guidelines which would create level-playing issues and competitive disadvantages for the UK. However, should the PRA remain intent on making this change in approach, we would like to understand the rationale. We recommend maintaining the SOT denominator at Tier 1 capital aligned with the BCBS 368 and the EBA Guidelines to maintain a level playing field with banks in the EU.

Limit and excess requirements

The supervisory outlier test was created to allow competent authorities to meet the objective of comparable and consistent review of IRRBB across banks. Although we believe that the most appropriate way to measure and monitor IRRBB is through an approved internal models approach that relies on the use of banks' internal measurement systems, we understand the supervisors desire for a tool that can be used across banks to help inform the supervisory assessment. The BCBS EVE outlier test was introduced as an Early Warning Indicator to trigger discussion with the competent authority and did not result in any automatic capital implications. We strongly believe that this should remain unchanged. Furthermore, the PRA should clearly state in the policy that the supervisory outlier test is a tool available for the supervisor to help assess banks' IRRBB, but is not a management metric that firms should actively manage to.

Our concern is that without this guidance banks will be strongly incentivised to manage IRRBB along the regulatory framework perception of risks, rather than focussing on their internal view of risk, particularly for institutions that prioritise the use of Earnings at risk (EaR) as their primary metric. To the extent that the regulatory framework departs from the way that risk is perceived and managed by firms, firms will face a dilemma: alignment to the risk perceived under the regulatory framework and the severe tail scenarios prescribed; or, managing actual risks under internally defined and approved stress scenarios. We are particularly concerned about this as whilst banks would be incentivised to create positions to mitigate risks under the prescribed SOT metric and scenarios, which are remote tail scenarios highly unlikely to materialise, such positions could increase the actual risk exposure under the bank's internal view of interest rate risk and more plausible scenarios which the bank should actually manage.

Risk free rates and inclusion of commercial margin

In our view, the EVE metric should be seen as a tool for measuring the value sensitivity of cash-flow mismatches in the current balance sheet. Should a firm include commercial margins and other spread components in its cash flows for the SOT, we believe it is valid to discount these cash flows using rates that either include or exclude these components depending on the risk profile, framework and system capabilities of the firm.

At a time when the regulatory and market environment for interest rates is transitioning towards risk-free rates we recommend that firms are given the flexibility to adopt either of the following approaches for the purposes of the SOT:

- discounting cashflows inclusive or exclusive of commercial margins using risk free or market benchmark rates, and
- discounting cashflows using rates inclusive of commercial margins if their cashflows also include such components.

Shocks by currency
Economic shocks for a number of currencies are included in the EBA guidelines but not in BCBS (BGN, CZK, DKK, HRK, HUF, PLN, RON). We recommend the PRA adopt the EBA guidelines shocks for these currencies.

Diversification benefits
In addition, and in line with previous consultations, we believe allowance should be made to take into account gains in one currency against losses in another when stress testing IRRBB. The current proposed approach increases the EVE sensitivity for any institutions with significant multicurrency balance sheets. Diversification benefits should be considered as long as the results are the outcome of documented and well governed hedging policies.

5. Treatment of FSA017
We are not supportive of the PRA's proposal to require all firms to report IRRBB on FSA017 in its current form and propose that further consultation on the PRA's reporting framework is undertaken before this requirement is introduced. Currently there is a number of different IRRBB reporting requirements in place across the industry:

- Bank and building societies produce the FSA017 return
- Systematically important institutions produce both the 022 and the FSA017 returns

However, Section 4.28 of the consultation paper states "that the PRA requires all firms to report on IRRBB in the form of FSA017". Further to this, section 4.30 of the consultation paper states that the PRA intends to consider revising FSA017 in order to ensure it continues to have sufficient information on firms' IRRBB. As FSA017, in its current form, would not serve to monitor IRRBB in accordance with the new rules, in our view, the PRA should remove the FSA017 reporting requirement for firms that are already submitting the 022 ALM Non Traded Market Risk template under the STDF, and not extend the FSA017 reporting to PRA designated investment firms until further consultation with the industry.

Instead, we suggest that the industry should be consulted in advance of any change in the PRA reporting framework in order to ensure that any revised reporting requirement is appropriate for its intended use to provide the PRA with sufficient information on firms' IRRBB under the new rules.

6. Proportionality
New and growing firms appreciate the recognition of proportionality and the option to use the standardised approach while they build out their capabilities and control environment. We would like to highlight a few specific points, where we request that the PRA give further consideration to apply the principle of proportionality.

Unlike sections 2.7 and 2.8, section 2.9 of the proposed SS 31/15 amendments in appendix 3 fails to mention proportionality ahead of setting out specific requirements. Smaller firms would find the requirements in 2.9B onerous, most particularly, the requirement for a 3-5 year time horizon for an earnings metric, particularly given the PRA's observations articulated in CP9/20 about forecasting uncertainties. Smaller member firms would welcome the addition of "where appropriate to its nature, size, and complexity as well as business activities and overall risk profile," to section 2.9.

Small firm members would also welcome setting the requirements in 2.9B (i) as 12 months, and this gradually increase towards the currently proposed 3 or 5 years as firms move towards a more settled,

less growth-focused balance sheet. This would align the proposal to the 1-3 year horizon of the BCBS framework (98.22). Firms with larger balance sheet / less growth compared to starting balance sheet are more likely to be able to provide accurate earnings sensitivities for longer time horizons.

New and growing firms face challenges as the Basel IRRBB standards require firms to use 10 years' history for behavioural modelling of non-maturity deposits. We trust that the emergence of new banks may not have been adequately provided for in the standards. Should the 10 years' minimum history be applied, as implied by the standard, firms will face a dilemma: alignment to the risk perceived under the regulatory framework and the severe tail scenarios prescribed; or, managing actual risks under internally defined and approved stress scenarios, in a similar fashion as described under heading Limit and excess requirements. New and growing firms would like to act prudently, apply behavioural assumptions through robust, well governed policies and internal models. Such firms would welcome the PRA's proportionate approach to the requirement on 10 years' history in its implementation of the Basel standard.

Question 2: Is it necessary to develop a simplified version of the standardised methodology?

We do not see the need for a simplified version of the standardised methodology.

Maximum Distributable Amount (MDA)

Question 3: Would the proposed amendments increase the usability of the combined buffer, and if so, to what extent?

Overall, the changes proposed to the MDA framework are considered positive. In particular, the revised definition of distributable profits (i.e. use of last four calendar quarters, instead of interim profits) provides for a simple adjustment to the definition of the MDA that leads to an increase in the usability of the combined buffer, while maintaining a degree of capital conservatism.

However, the industry believes the changes do not provide enough flexibility in situations where the last four quarters of profits (net of distributions) are negative. In such cases, the MDA will remain zero. We would therefore propose that the PRA take steps to further align with BCBS standards by recognising the benefits of capital infusions within the MDA framework, whether automatically or on a discretionary basis. In particular, section 30.4 of the Basel Framework states that *"If the bank wants to make payments in excess of the constraints imposed by this regime, it would have the option of raising capital in the private sector equal to the amount above the constraint which it wishes to distribute."*

We believe that this change would further reduce the incentive for firms to deleverage, rather than use their combined buffer, but would not result in capital depletion due to the incremental capital being raised. The inclusion of additional language such as the below would provide the appropriate flexibility, consistent with the PRA's objectives, and could be made subject to PRA approval:

> "and the sum of the last four calendar quarter profits (as defined in Capital Buffers 4.3(5)) *plus increases in CET1 resources due to issuance of shares*, net of any distribution of profits…"

Finally, in the draft rule (extract below), footnote 25 should be deleted.

3. Capital conservation measures

3.1 Firms may use their combined buffer as required in times of stress, but should not use it in the normal course of business or propose to enter it as part of their base business plan. As set out in the PRA's capital buffers rules, firms that do not meet their combined buffer shall face restrictions on their distributions, and be subject to a maximum distributable amount (MDA).[25] The MDA must be calculated as the product of 60%, 40%, 20% or 0% (depending on which quartile of its combined buffer the firm is in)[26] and the sum of the last four calendar quarter ~~interim and year-end~~ profits (as defined in Capital Buffers 4.3(5)), net of any distribution of profits or any payment resulting from:

a) making a distribution in connection with Common Equity Tier 1 capital;

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22 This supervisory statement instead does not address the PRA's expectations on the relationship between MREL and buffers, which are set out in SS 16/16,'The minimum requirement for own funds and eligible liabilities (MREL) – buffers and Threshold Conditions'.

23 http://fshandbook.info/FS/html/PRA/D226.

24 www.bankofengland.co.uk/pra/Pages/supervision/approach/default.aspx.

25 Firms that do meet their combined buffer cannot make a distribution that will cause them to stop meeting it.

26 Where firms are in the first quartile of their combined buffer (when they meet between 75% and 100% of it), 60% of such

Variable risk weights for real estate exposures

Paragraph 9.8 of PRA CP 17/20 says, “For the purposes of Credit Risk 4.1 and 4.1A, Credit Risk 4.2 specifies that ‘a representative period shall be a time horizon of sufficient length and which includes a mix of good and bad years’. The PRA does not consider the requirements of ‘a representative period’ to have been met, as current data do not cover an adequate mix of good and bad years. The PRA considers that a full credit cycle must be observed in the UK (or a given non-EEA jurisdiction) CRE market before these data would be available.”

One proposal is that a full credit cycle will comprise the time horizon covering the 2008 financial crisis to the 2020 pandemic crisis providing sufficient data for a mix of ‘good’ and ‘bad’ years.

For transparency, given the clarity provided by the PRA on what a representative period covering a full credit cycle, would the PRA consider publishing the lending secured by mortgages on commercial property data it does have – via COREP and FINREP reporting - to allow the industry to track and further understand the PRA’s position.

Separately the annual “Banking supervisory disclosures: rules and guidance, options and discretions, SREP, and aggregate statistical data” contains immovable property loss data in part 2 of annex 4, last published in July 2020. It might be useful if the PRA would consider providing us with insight on how it uses this (or any other) information in concluding on the 100% risk weight. It would be useful for us to understand what would be considered sufficiently low loss rates and how this has been segmented given the lack of homogeneity within this asset class.

Should the PRA require further detail, members would be open to working with the PRA through UK Finance to come up with proposals on how to incorporate specific loss data submission into the regulatory reporting suite to inform the appropriate calibration of Pillar 1 risk weights.

Other matters

We welcome the recent statement from HMT, PRA and FCA on delaying the implementation of CRR2 until 1 January 2022, particularly in light of the volume of financial services regulatory reform in 2021 as the authorities have identified. Since the implementation of CRR2 introduces significant operational and resource challenges, we would particularly appreciate clarity on the intended approach to, and continued engagement on, a number of key CRR2 provisions, including SA-CCR alpha factor, FRTB Standardised approach reporting, Net Stable Funding Ratio, Leverage Ratio, exposure to CCPs, and exposure to collective investment undertakings, in terms of international level playing field and the attractiveness of the UK as a financial centre.

Of course, I and UK Finance members would be delighted to discuss the content of this response with the PRA if that would be helpful.

Responsible Executive

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