UK FINANCE

A response to the PRA's consultation paper CP2/20 on

Reconciling capital requirements and macroprudential buffers in Pillar 2A

30th April 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 PRA's Consultation Paper 2/20 on its intention to reduce Pillar 2A capital add-ons in the light of the greater additional resilience associated with the higher countercyclical buffer (CCyB) as recorded in the Minutes of the Financial Policy Committee meeting held on December 13th 2020.

Without any offsetting action, increasing the standard risk environment CCyB to 2% would have resulted in an increase in overall capital levels. We fully support the FPC's decision on 9th March 2020 to reduce the buffer to zero in the light of the possibly profound impacts of the current Covid-19 pandemic on economic activity. This capital reduction will ensure that banks and building societies can continue to support UK businesses and households so that any Covid-19 related economic disruption will not cause lasting harm.

Despite the reduction in CCyB to 0% 2020, in response to Covid-19, it remains prudent to consider the impact of the forthcoming increase in the standard CCyB rate to 2% and the appropriate action required to ensure that the overall loss-absorbing capacity in the banking system remains broadly unchanged.

We look forward to continuing to work with the PRA to identify a methodology that will enable all firms to benefit from the full CCyB offset through a reduction of Pillar 2A requirements or via other mechanisms, recognising that this is an inherently difficult task.

Not all firms will benefit from full a CCyB offset increasing their cost of capital

We feel that the PRA's assertion that the Minimum Requirement for own funds and Eligible Liabilities (MREL) will remain 'broadly constant' is not correct and total capital requirements (given only 50% of the impact is given as Pillar 2A relief at the capital level) will increase, as well as increasing the proportion met with Common Equity Tier 1 (CET1).

Also, as the PRA has acknowledged, there will be a proportion of our systemic and non-systemically important members which will not benefit from the full Pillar 2A reduction in relation to their UK assets and will potentially receive no applicable offset at all. These including those that:

- are leverage-constrained
- have a simpler business models requiring minimal Pillar 2 A add-ons
- are subject to a 'partial transfer' resolution strategy scaled down based on their retail deposits
- are subject to transitional internal MREL requirements
- are not deemed 'low risk',

In addition, these firm's overall cost of capital is likely to increase by a greater margin. This is because as the CCyB must be held in the highest-quality and most expensive form of capital, CET1, but without any reduction in CET1, Additional Tier 1 (AT1) and Tier 2 capital required to meet Pillar 2A capital and subordinated debt for MREL being realised.

The PRA acknowledged that there will be certain institutions, whose interim MREL is not a function of Pillar 2A, whose LAC will increase during the transition period.

That the Pillar 2A reduction will not apply to all firms is a source of concern for those members that will be disproportionately impacted by the proposals which may also have detrimental impacts on competition in the short to medium term.

Interactions with the Leverage and MREL frameworks

The capital framework for banks has evolved significantly since the global financial crisis and has certainly become more complex.

Banks are now required to meet a Leverage Ratio (LR) requirement based on un-risk adjusted exposures. In addition, they are required to hold MREL to support an effective resolution. Eligible liabilities include subordinated debt, which is issued to third parties, who understand that in the event of a resolution strategy requiring bail-in, their investments will be written down. This feature means that MREL is expensive compared to senior debt, particularly so for smaller institutions that may issue in sub 'market size' and only infrequently.

As the CP notes there are interactions between the LR and MREL requirements which are independent of the level of Pillar 2A that is set. The PRA and FPC should therefore seek to consider the impacts across all aspects when making policy decisions.

The average risk weighting for a bank is a combination of both modelled risk weighting and business mix, and so the Leverage Ratio can inappropriately penalise banks who focus on genuinely low risk exposures.

Firms which are bound by the UK leverage ratio requirements will automatically suffer higher LAC requirements from the increased CCyB level in a standard risk environment. This is because PRA policy on buffers requires capital buffers to be additive to both Bank of England and EU CRR2 MREL requirements, such that they remain useable in stress.

So, firms bound by leverage will have an increase in MREL requirements equal to the increase in their firm specific UK CCyB rate, with no Pillar 2A reduction. In contrast, firms bound by RWA, with a bail-in resolution strategy, will see no change in end-point MREL requirements as any increase in their firm specific CCyB rate will be offset through the twice the Pillar 2A adjustment granted by the PRA.

This prevents the PRA meeting its objective for these proposals which is to keep LAC broadly constant.

The PRA should therefore seek to amend the LR, MREL or both frameworks across all firms to provide a consistent and level playing field. For example, this could be implemented through a reduction in minimum leverage requirements to 3% or by setting the leverage based MREL requirement as 6% of leverage exposure.

We understand that the Resolution Authority and PRA intend to review the MREL and Leverage regimes, in separate studies, over the coming year and then to consider the Pillar 2 regime after the finalised Basel 3.1 regime is implemented. We strongly urge the UK authorities to undertake the planned MREL and Leverage regime reviews in parallel, rather than sequentially, as we understand is currently the plan, and to bring forward its review of the Pillar 2 regime. In our view all three studies should be undertaken concurrently and ideally coordinated at an international, not local level, in order that any amendments can be applied by internationally active banking groups in a harmonised, internationally consistent way.

Internal MREL – applying the reduction

Material subsidiaries which are not themselves resolution entities are subject to an internal MREL requirement at a sub-consolidated level, scaled at between 75% and 90% of their external MREL requirement.

Firms subject to internal MREL will see a larger increase in their MREL requirements relative to firms that are subject to external MREL requirements. On an end-point basis, both internal and MREL firms will receive 2 times the Pillar 2A reduction in their MREL requirement calibration. However, this reduction will be scaled by 75% - 90% for internal MREL firms, which reduces the size of the Pillar 2A offset relative to the increase in the CCyB. This highlights the disparity in impact for internal and external MREL firms and supports our prior assertion that LAC would be left broadly unchanged.

The PRA should reduce MREL requirements for such firms to maintain the intention of the proposed policy of keeping LAC/ MREL requirements broadly unchanged. An example of how this can be achieved is by applying an "MREL adjustment" to either the MREL eligible resources (by reducing the CCyB deducted from resources) or MREL requirements as suggested below:

MREL adjustment = (1 – internal MREL scalar) x increase in institution specific CCyB rate.

Additionally, the consultation paper does not envisage any adjustment of requirements for firms whose MREL is a proportion of RWA (for example firms subject to CRR II MREL requirements). Such firms do not realise the benefit of the reduction in Pillar 2A, with the full increase in CCyB impacting MREL. For example, if the institution-specific countercyclical buffer rate increases by 1% of RWA, the surplus over MREL requirements would reduce by 1% of RWA. PRA is urged to revisit the applicability of the increase in CCyB to MREL requirements in such cases. This could be achieved by reducing the CCyB (to be deducted from MREL eligible resources) by the increase in the institution specific CCyB rate.

A similar approach could be applied to firms bound by leverage (which will not benefit from a Pillar 2A reduction) to neutralise the impact on MREL for leverage constrained firms.

Timing

The PRA made it clear that any subsequent changes to the CCyB rate following the FPC change in its steady state expectation would not be reflected in further Pillar 2A reduction. Given that the reduction in the CCyB to 0% occurred after the FPC announcement, our expectation is that the 1% Pillar 2A reduction will be applied once the policy proposed in this CP comes in to effect in July.

We understand that the PRA anticipates that all firms will be notified of their revised Pillar 2A requirements at the same time or before the 2% standard UK CCyB rate would have come into effect on Wednesday 16th December 2020.

We would appreciate the PRA's early confirmation that this will indeed be the case.

Dynamics of Pillar 2 A reduction adjustment

A firm's aggregate CCyB will be a function of the weighted average of all the CCyBs in each jurisdiction in which it operates. An important effect of increasing the standard economic environment rate to 2% is that non-UK firms will be required to hold more capital against their UK exposures, without necessarily being able to apply the corresponding reduction in Pillar 2A, given these are not within the remit of the PRA, but the home state regulator.

The impact of the 1% to 2% increase in the UK CCyB rate will change over time as total RWAs and the geographic composition of exposures change. Firms would therefore appreciate clarity on how the Pillar 2A adjustment will be revised as the firm specific impact of the 1% UK CCyB increase changes. If this is linked to the SREP, as we believe is suggested in the CP, then firms may see higher capital requirements through the CCyB increase with no offsetting Pillar 2A reduction for up

to one year (or longer for firms not on an annual SREP cycle). We suggest firms should be able to make dynamic P2A adjustment as the CCyB impact changes, rather than waiting for their next SREP.

We and our members would of course be pleased to discuss the contents of this letter with the PRA as it finalises it policy on the offsetting of the CCyB increase through Pillar 2A reductions.

Responsible Executive

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