BANK OF ENGLAND

News release

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PRA launches consultation on Pillar 2A capital framework

Today the PRA has taken a significant step to facilitate effective competition with proposals that reduce any risk that smaller banks and building societies are disadvantaged by the approach we take to setting capital requirements.

The work delivers a commitment made in the PRA's Annual Competition Report 2016 to address the disparity in risk weights between firms using the standardised approach and firms that use their own models.

Refining our Pillar 2A (P2A) capital framework, the PRA will reduce the disparity in capital requirements between the Standardised Approach (SA), mainly used by smaller banks and building societies, and the Internal Ratings Based Approach (IRB). The changes will help ensure our capital standards are not overly prudent for smaller firms, facilitating effective competition. The proposals should also contribute to the safety and soundness of firms by reducing incentives for SA lenders to specialise in higher loan-to-value mortgages.

To achieve these aims the consultation paper proposes the following refinements to its P2A capital framework:

- PRA supervisors will be able to take into account the greater degree of conservatism that may apply to risk weights derived from the SA compared to those from IRB models for certain types of exposure – notably mortgages.
- When doing so, supervisors will use updated IRB credit risk benchmarks (average risk weights for different types of exposure across firms that use IRB models).
- Supervisors will take into account a range of additional factors when setting P2A capital including: the outcome of the PRA's existing P2A methodologies for capitalising different types of individual risks, firms' own assessment of the amount of capital they need to maintain given the risks on their balance sheets, firms' overall business model and risk profile (including the quality of risk management and governance), and peer comparisons.

- The PRA also proposes to use the refined P2A approach to mitigate potential double counting of expected credit losses for SA firms under the new International Financial Reporting Standard (IFRS) 9 which will apply from 1 January 2018.

Sam Woods, Deputy Governor for Prudential Regulation said: "This consultation is a major step forward for the PRA in facilitating effective competition, reducing capital requirements for eligible small firms. This will be good for competition and for safety and soundness."

ENDS

Notes to Editors

1. Consultation Paper 3/17 'Refining the PRA's Pillar 2A capital framework'
2. Extract on Pillar 2A from Sam Woods Mansion House Speech, October 2016: *"I intend that we will bring forward proposals under our Pillar 2 regime which should…reduce the risk that our capital standards are overly prudent for smaller firms using the standardised approach to credit risk to calculate their requirements – essentially by looking at capital requirements in the round rather than assuming that a simple "sum of the parts" approach will necessarily deliver the right answer."*
3. The PRA will be hosting a seminar on 24 February 2017 for small and mid-tier firms on the Internal Ratings Based Approach – a summary will be published soon after the seminar.
4. The PRA has three statutory objectives:
    a. A general objective to promote the safety and soundness of the firms it regulates;
    b. An objective specific to insurance firms, to contribute to the securing of an appropriate degree of protection for those who are or may become insurance policyholders; and
    c. A secondary objective to facilitate effective competition.