BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

Consultation Paper | CP3/17

Refining the PRA's Pillar 2A capital framework

February 2017

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Responses are requested by Wednesday 31 May 2017.

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1 Overview

1.1 This consultation paper (CP) sets out proposed adjustments to the Prudential Regulation Authority's (PRA) Pillar 2A capital framework which came into force on 1 January 2016.[1] It is relevant to banks, building societies and PRA-designated investment firms.

1.2 The PRA is proposing to refine its Pillar 2A approach for firms using the standardised approach (SA) for credit risk. In particular, the PRA may exercise its supervisory judgement to adjust a firm's Pillar 2A add-ons, as assessed by applying the PRA's methodologies,[2] to ensure that the total amount of capital required does not exceed the amount necessary to ensure a sound management and coverage of its risks.

1.3 International Financial Reporting Standard (IFRS) 9 will apply for accounting periods beginning on or after 1 January 2018. The PRA is also proposing to consider, as part of the supervisory review and evaluation process (SREP), the extent to which expected credit losses (ECL) in IFRS 9 may already be covered by the SA Pillar 1 capital charge.

1.4 Finally, the PRA is consulting on an update to its credit risk benchmark (the 'IRB benchmark') which is part of the Pillar 2A credit risk methodology,[3] and on amendments to the Pillar 2 reporting rules.

Background

1.5 The PRA sets Pillar 2A capital for risks which are either not captured, or not fully captured, under the Capital Requirements Regulation (575/2013) (CRR). It assesses those risks as part of the SREP, in light of both the calculations included in a firm's Internal Capital Adequacy Assessment Process (ICAAP) document and the PRA's Pillar 2A methodologies set out in its 'Statement of Policy – The PRA's methodologies for setting Pillar 2 capital' ('SoP').[4]

1.6 The PRA's Pillar 2A credit risk methodology is based on a comparison of firms' SA risk weights to risk weights derived from internal-rating based (IRB) models (the 'IRB benchmark'). The IRB benchmark suggests that for certain asset classes (eg credit cards) the SA for credit risk may underestimate the risk, in which case supervisors may want to apply a Pillar 2A capital add-on. For others, such as residential mortgages with a low loan-to-value (LTV) ratio, the level of capital required under the SA is significantly higher than the Pillar 1 capital charge implied from average IRB risk weights.

1.7 The PRA has expressed some concerns about the potentially conservative nature of the SA compared to IRB risk weights, especially for asset classes that are considered lower risk.[5] These concerns have been shared by the Competition and Markets Authority in its retail banking market investigation concluded in August 2016.[6]

1.8 In particular, the PRA is concerned by empirical evidence which suggests that the difference between SA and IRB risk weights may distort incentives in the mortgage market.

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1 PRA Policy Statement (PS)17/15 UPDATE 'Assessing capital adequacy under Pillar 2', August 2015: www.bankofengland.co.uk/pra/Pages/publications/ps/2015/ps1715update.aspx.
2 Statement of Policy UPDATE 'The PRA's methodologies for setting Pillar 2 capital', February 2017: www.bankofengland.co.uk/pra/Pages/publications/sop/2017/p2methodologiesupdate.aspx.
3 See footnote 1.
4 See footnote 2.
5 Speech given by Sam Woods, Deputy Governor, Prudential Regulation and Chief Executive Officer, PRA, at the City Banquet, Mansion House, London, http://www.bankofengland.co.uk/publications/Documents/speeches/2016/speech933.pdf.
6 Available at: https://assets.publishing.service.gov.uk/media/57ac9667e5274a0f6c00007a/retail-banking-market-investigation-full-final-report.pdf.

Firms using IRB models appear to specialise in low LTV mortgages, given the comparative advantage provided by their risk weights, while those using the SA tend to specialise in high-LTV mortgages for which the gap in risk weights between the two approaches is smaller.[1] This gap may create an incentive for firms using the SA for credit risk to specialise in riskier exposures. This could affect their safety and soundness.

1.9 As noted in its 2016 Annual Competition Report,[2] the PRA has already taken steps to tackle these concerns, including under the Pillar 2 capital regime. Under the PRA's Pillar 2A credit risk methodology,[3] if the IRB benchmark implies that the SA for calculating the Pillar 1 capital charge overestimates the overall level of capital for a given portfolio when compared with IRB models, the calculated excess can be offset against shortfalls in those portfolios for which the benchmark implies that the SA Pillar 1 capital charge is lower than the IRB capital charge. In addition, residential mortgage portfolios subject to the SA are excluded from the PRA's assessment of geographic concentration risk.

1.10 Recent initiatives, notably the Leverage Ratio and the Systemic Risk buffer, have also helped to reduce disparity in capital requirements between SA and IRB firms. This is because the Systemic Risk buffer applies only to large lenders, typically using models, while smaller lenders, typically on the SA, are exempt; and the Leverage Ratio effectively acts as a floor preventing risk-weights from leading to excessive leverage. The Basel Committee on Banking Supervision (BCBS) has also proposed revisions to the standardised and IRB approaches to credit risk, that aim at increasing the risk sensitivity of the SA while reducing excessive variability in modelled risk weighted assets. These proposals would further diminish differentials in capital requirements between both approaches. However, these measures alone may not be sufficient or timely enough in their implementation to tackle the risks such differentials pose for the safety and soundness of SA firms, as set out in paragraphs 1.8 and 1.9, and their ability to compete effectively against IRB firms.

1.11 Furthermore, the introduction of IFRS 9 could exacerbate differences between the impacts of the two approaches. Under IFRS 9, firms' provisions will no longer be based on an incurred loss measure but on twelve months' ECL for performing assets and lifetime ECL for under and non-performing assets. Consequently, the level of credit loss provisioning is expected to increase. For smaller firms, most of which use the SA, this will lower their retained earnings and directly reduce the level of Common Equity Tier 1 (CET1) capital.

1.12 Although increased provisions will also affect the retained earnings of IRB firms, the impact on their level of CET1 capital is likely to be less significant. This is because IRB firms are required, in effect, to deduct the higher of accounting provisions and the IRB measure of expected loss from their CET1 capital. Therefore, increased provisions under IFRS 9 will only reduce CET1 to the extent increased provisions exceed the IRB measure of expected loss.

1.13 Additionally, IFRS 9 may result in a 'double-counting' of expected losses within the SA. This is because SA risk weights may already reflect expected losses to an extent. This is not the case for the IRB approach, under which risk weights only take into account unexpected losses.

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1 Benetton, M, Eckley P, Garbarino N, Kirwin L, Latsi G (2016), 'Specialising in risky mortgages: unintended consequences of Basel II', Bank of England, http://www.bankofengland.co.uk/research/Pages/workingpapers/2017/swp639.aspx.

2 PRA Annual Competition Report, June 2016: www.bankofengland.co.uk/publications/Documents/annualreport/2016/compreport.pdf.

3 See footnote 2, page 5.

1.14 The PRA considers that these issues may justify adjustment to the PRA's current Pillar 2A approach for firms using the SA and this may apply in particular to firms using IFRS as their accounting framework.

1.15 To estimate the higher degree of conservatism of the SA compared to IRB models, the PRA also proposes to update the calibration of the IRB benchmark.

Purpose

1.16 The purpose of these proposals is to make the PRA's Pillar 2A capital assessment more robust and more proportionate by addressing some of the concerns over the differences between SA and IRB risk weights and by updating the calibration of the IRB benchmark. They are aimed at promoting the safety and soundness of PRA-regulated firms, as well as facilitating more effective competition in the banking sector.

Implementation

1.17 The proposed implementation date for the updated Pillar 2A capital framework is 1 January 2018.

1.18 The PRA will assess whether ongoing adjustments to the Pillar 2A approach may be required in light of developments on the proposed revisions by the BCBS to the standardised and IRB approaches for credit risk.

1.19 In parallel, the BCBS and the European Commission are considering transitional measures to smooth the impact of IFRS 9 on regulatory capital.[1] The European Commission is proposing to phase in the capital impact of the IFRS 9 ECL requirements over a five year period. The PRA will take such transitional measures, as well as further BCBS proposals, into consideration when setting Pillar 2A capital for SA firms using IFRS 9 as their accounting framework.

1.20 This policy has been designed in the context of the current UK and EU regulatory framework. The PRA will keep the policy under review to assess whether any changes would be required due to changes in the UK regulatory framework, including those arising once any new arrangements with the European Union take effect.

Responses and next steps

1.21 This consultation closes on Wednesday 31 May 2017. The PRA invites feedback on the proposals. Please address any comments or enquiries to CP3_17@bankofengland.co.uk.

2 Proposals

2.1 The proposals in this CP cover three areas:

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

(ii) revisions to the IRB benchmark; and

1 The European Commission Proposal for a regulation of the European Parliament and of the Council amending Regulation (EU) No 575/2013 as regard the leverage ratio, the net stable fund ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements and amending Regulation (EU) No 648/2012, November 2016: http://ec.europa.eu/finance/bank/regcapital/crr-crd-review/index_en.htm#161123.

(iii) additional considerations, as part of the SREP, for SA firms using IFRS as their accounting framework.

2.2 They are set out as amendments to the SoP, Supervisory Statement (SS) 31/15 'Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP),'[1] SS32/15 on Pillar 2 reporting instructions,[2] and the Pillar 2 Reporting Part of the PRA Rulebook. These amendments are detailed in Appendices 1 to 4 of this CP.

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

2.3 The PRA is proposing to adjust its Pillar 2A approach for firms using the SA for credit risk. This new approach may 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.

2.4 The PRA is proposing that in setting Pillar 2A capital it would carry out an overall assessment of the level of capital that would be sufficient to ensure a sound management and coverage of firms' risks, taking into account the nature, scale and complexity of their activities. A judgement on the higher degree of conservatism that may apply to certain asset classes under the SA, as informed by comparing firms' SA Pillar 1 capital charges to the upper range risk weights of the IRB benchmark, would inform the setting of Pillar 2A capital. The overall assessment would not mechanically link to the benchmark but would also be informed by other factors, including the outcome of the PRA's Pillar 2A methodologies, firms' ICAAP, business model analysis – including consideration of whether the benchmark was representative of firm-specific risk profiles – and peer reviews.

2.5 As part of this approach the PRA would estimate the extent to which the application of the PRA's own Pillar 2A methodologies for credit risk would lead to a firm maintaining capital in excess of the amount necessary to ensure a sound management and coverage of risk. Any excess could then be used to adjust the firm's variable Pillar 2A capital add-ons in circumstances where the PRA considers that the firm is relatively low-risk and well managed and that the adjusted level of capital is adequate in relation to the risks to which the firm is or might be exposed. The fixed elements of Pillar 2A, usually set for pension obligation risk, would not be adjusted to ensure that capital remains available to meet claims arising from pension obligations. Other fixed add-ons, which may be set for IT risk for instance, would similarly be unadjusted.

2.6 For the purpose of informing this assessment, the PRA would require all firms using the SA for their credit risk portfolios to report the Pillar 2 data items on wholesale and retail credit exposures (FSA076 and FSA077 in Appendix 5) alongside their ICAAP submission. As these data items would no longer be requested on a case-by-case basis, but rather would be required to be submitted on a regular basis by all firms using the SA, the PRA proposes to include them in the Pillar 2 Reporting Part. Where the PRA considers that the quality of the data submitted is not satisfactory, the proposed adjustments to the Pillar 2A approach would not apply.

2.7 In line with SS31/15, the PRA would continue 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. The ICAAP would inform the size of the adjustments to the variable Pillar 2A add-ons. If a firm is merely attempting to replicate the PRA's own methodologies, it will not be carrying out its own assessment in accordance with the Internal Capital Adequacy Assessment Part.

1 February 2017: www.bankofengland.co.uk/pra/Pages/publications/ss/2017/ss3115update.aspx.
2 February 2017, www.bankofengland.co.uk/pra/Pages/publications/ss/2016/ss3215update.aspx.

2.8 Where the PRA determines that the arrangements, strategies, processes and mechanisms implemented by a firm do not ensure a sound management and coverage of its risks, or where a firm has concentrated exposures to asset classes for which the PRA does not have sufficient data to produce a reliable IRB benchmark, its Pillar 2A capital add-ons would not be adjusted as part of the proposed Pillar 2A refined approach.

Revisions to the IRB benchmark

2.9 The PRA is proposing to update its IRB benchmark (Appendix 1) using end-2015 data collected via regulatory returns, stress testing, and the Pillar 2 data item FSA082.

2.10 This updated benchmark would continue to underpin the PRA's methodology for credit risk. It would also be used as part of the proposed Pillar 2A adjusted approach for firms using the SA for credit risk, to inform the setting of Pillar 2A capital add-ons.

2.11 Consistent with the way they were previously calculated, the updated average IRB risk weights are weighted by exposure amount and include a measure of unexpected and expected losses.

2.12 Two adjustments are proposed to the coverage of the benchmark. First, a benchmark for personal loans would be added. Second, the benchmark for sovereigns within credit quality step six ('substantial risks') would be removed because the sample size of firms with assets in this category is too small.

2.13 In general, the PRA expects to see some movement when refreshing this benchmark due to changes in risk profile, changes in firms' internal models, data quality improvements, and the evolving external risk environment.

2.14 As noted in the SoP, part of the formalisation of the IRB benchmark was to utilise new datasets which the PRA believes provide a more robust calculation of average risk weights, when available. The updated benchmark is derived from Pillar 2 regulatory returns as well as data used for stress testing. This change in data source may cause some variation in the risk weights outlined in Table A of Appendix 1. The PRA has noted an increase in average risk weights by LTV band for mortgages. This may be partially driven by rising house prices causing migration of higher risk accounts into lower LTV bands as the value of the property the loan is secured upon increases.

2.15 In addition to the factors noted in 2.13, firms that have IRB permission will continue to roll out IRB to new exposure classes, and firms will continue to be granted new IRB permissions, both of which increase the pool available for benchmarking. As such, the PRA monitors average IRB risk weights and would look to update the IRB benchmark when substantive changes are observed.

2.16 The PRA also proposes a change to the application of the benchmark for commercial real estate (CRE) exposures. Evidence indicates that IRB firms' CRE exposures differ significantly from SA firms' portfolios. In addition, there is heterogeneity in the nature and riskiness of CRE exposures between SA firms.

2.17 Purely for the purpose of assessing potential conservatism in SA risk weights, and to ensure that the benchmark reflects an appropriate level of risk sensitivity, the PRA encourages SA firms with material CRE exposures to assign these, as part of their ICAAP, to the risk weight

category for specialised lending exposures[1] in accordance with the draft EBA technical standards on specialised lending exposures.[2] The PRA's assessment of the degree of conservatism of risk weights that may apply for CRE exposures would be informed by the outcome of the firms' assignment of risk weights and the quality of their assessment. Where firms' CRE portfolios are not material, the PRA makes the assessment on the basis of the published range in the IRB benchmark taking a proportionate approach. It should be stressed that SA firms must continue to use the standardised risk weights as normal: any result from the slotting assessment would be just one factor the PRA will take into account in assessing firms' capital adequacy. To reflect this adjustment, the published range of risk weights has been expanded to encompass the full extent to which firms' CRE portfolios may vary.

Additional considerations for SA firms using IFRS as their accounting framework

2.18 For firms using the SA for credit risk and IFRS as their accounting framework, the PRA is proposing to introduce a separate IRB benchmark, based on unexpected losses. Expected loss would be removed from the calculations of the average IRB risk weights.

2.19 This separate benchmark would help to provide an estimate of the higher degree of conservatism that may apply to SA firms using IFRS as their accounting framework. SA risk weights may already reflect expected losses to an extent. So part of the difference between SA and IRB risk weights, excluding IRB firms' average estimated expected loss amount from the calculations, may be attributable to some extent to a proxy of SA firms' ECL.

2.20 This benchmark would inform the assessment of credit risk and the setting of Pillar 2A capital as part of the proposed adjusted Pillar 2A approach for IFRS firms.

2.21 As noted in paragraph 1.18, should the application of IFRS 9 be subject to transitional arrangements, the PRA would take these into consideration when assessing firms' capital adequacy.

3 The PRA's statutory obligations

3.1 The PRA has a statutory duty to consult when introducing new rules and a public law duty to consult widely on any other measures that significantly affect firms.

Compatibility with the PRA's objectives

3.2 In discharging its general functions of making rules, and determining the general policy and principles by reference to which it performs particular functions, the PRA must, so far as reasonably possible, act in a way that advances its general objective to promote the safety and soundness of the firms it regulates. These proposals advance the PRA's general objective by ensuring that the level of Pillar 2A capital firms are expected to maintain is adequate in relation to the risks they are or may be exposed to. They should also reduce the incentive for SA lenders to specialise in higher risk lending, such as high LTV mortgages, which can endanger the safety and soundness of firms.

3.3 When discharging its general function in a way that advances its primary objectives, the PRA has, as a secondary objective, to facilitate effective competition. These proposals will help advance that objective through introducing a more proportionate Pillar 2A approach for firms

1 Article 153(5) CRR.
2 June 2016, www.eba.europa.eu/-/eba-publishes-final-draft-technical-standards-on-specialised-lending-exposures.

using the SA for their credit risk exposures which should reduce the disparity in capital requirements between SA and IRB firms.

Cost benefit analysis

3.4 The PRA is also required to perform an economic assessment of the impact of its policy proposals.

3.5 The PRA expects the proposals in this CP to lower Pillar 2A capital add-ons for some firms using the SA for credit risk. Supervisors will be able to adjust the level of Pillar 2A capital downwards, where appropriate. This is also likely to have implications for the setting of the minimum requirement for own funds and eligible liabilities (MREL). As set out in the Bank of England's approach to setting MREL,[1] while MREL will be set on a case-by-case basis, the Bank expects to require institutions that are subject to a bail-in or partial transfer preferred resolution strategy to meet an end-state MREL based on two times their regulatory capital requirements (ie 2 x (Pillar 1 plus Pillar 2A) or twice the leverage ratio if applicable). Any reduction in Pillar 2A capital add-ons may therefore reduce the level of MREL set by the Bank of England.

3.6 The proposed refinements to the PRA's Pillar 2A approach should help to narrow discrepancies in capital requirements between the SA and IRB models, by reducing the comparative advantage provided by IRB risk weights on certain asset classes. While firms using the SA for credit risk have tended to specialise in high LTV mortgages, the proposals may encourage them to expand into lower LTV mortgage lending.

3.7 The proposals should facilitate a more even distribution of risks arising from mortgage exposures. This would contribute to the safety and soundness of individual firms. The proposals should also facilitate competition in the banking sector, notably for smaller firms, building societies and challenger banks.

3.8 The costs to firms using the SA for credit risk of reporting their credit risk data alongside their ICAAP submission should not be material. Under the current Pillar 2A credit risk approach, these firms may already be requested to submit these data on a case-by-case basis where supervisors assess that they are likely to need a Pillar 2A credit risk add-on, therefore firms should already have the necessary systems in place to provide such data to the PRA.

3.9 The PRA's proposal to use IRB credit risk benchmarks to estimate the higher degree of conservatism that may apply under the SA does not imply that IRB risk weights are a perfect reflection of underlying risk. To ensure a prudent application of the benchmarks, the PRA proposes to use the upper range as a floor, rather than the average risk weights, when comparing firms' Pillar 1 SA capital charge to the IRB capital charge, although this process is not mechanistic and will depend on whether the benchmark is representative of firm-specific risk profiles. The approach will also consider differences in Pillar 2A credit concentration risk add-ons between firms using the SA and IRB models, as noted in paragraph 1.9 of this CP, when comparing the overall level of capital firms are expected to maintain under these two approaches. And the PRA would only consider adjusting Pillar 2A add-ons downwards where a firm is considered as low risk and well managed.

3.10 The PRA expects that proposed BCBS revisions to the SA and IRB models would lead to smaller differences in capital requirements between the two approaches. This implies that the

1 The Bank of England's approach to setting a minimum requirement for own funds and eligible liabilities, November 2016: www.bankofengland.co.uk/financialstability/Documents/resolution/mrelpolicy2016.pdf.

size of the proposed adjustments to Pillar 2A add-ons should become smaller over time. As noted in paragraph 1.18, the PRA will consider whether further refinements to its Pillar 2A framework are needed if revisions are implemented.

Regulatory principles

3.11 In developing the proposals in this CP, the PRA has had regard to the regulatory principles. One of the principles is of particular relevance.

3.12 The principle that the desirability where appropriate of each regulator exercising its functions in a way that recognises differences in the nature and objectives of businesses carried on by different persons (including different kinds of persons such as mutual societies and other kinds of business organisation) subject to requirements by or under the Financial Services and Markets Act. The PRA has followed this principle when developing the proposals outlined in this CP and considers that the proposed Pillar 2A approach for firms using the SA for credit risk would result in proportionate Pillar 2A capital add-ons relative to the nature of the risks to which these firms are or may be exposed.

Impact on mutuals

3.13 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.

Equality and diversity

3.14 The PRA is also required by the Equalities Act 2010 to have due regard to the need to eliminate discrimination and to promote equality of opportunity in carrying out its policies, services and functions. The PRA has performed an assessment of the policy proposals and does not consider that the proposals give rise to equality and diversity implications.

Appendices

1	**Draft amendments to Statement of Policy 'The PRA's methodologies for setting Pillar 2 capital'**
2	**Draft amendments to SS31/15 'The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)'**
3	**Draft amendments to Supervisory Statement 32/15 'Pillar 2 reporting, including instructions for completing data items FSA071 to FSA082'**
4	**PRA RULEBOOK: CRR FIRMS: REPORTING PILLAR 2 AMEDNMENT NO.1 INSTRUMENT 2017**
5	**Reporting templates FSA076 and FSA077**

Appendix 1: Draft amendments to 'Statement of Policy – The PRA's methodologies for setting Pillar 2 capital'

This appendix outlines proposed amendments to Chapter 2 on credit risk of 'Statement of Policy - The PRA's methodologies for setting Pillar 2 capital'.

Underlining indicates new text and striking through indicates deleted text.

…

Methodology for assessing Pillar 2A capital for credit risk

2.6 The methodology used to inform the setting of firms' Pillar 2A individual capital guidance for credit risk is based on a comparison of firms' SA risk weights at a portfolio level to an IRB risk-weight benchmark. The PRA has created two benchmarks. One is calculated based on both unexpected and expected losses (see **Table A**). The other is based on unexpected losses only (see **Table B**). The latter applies to firms using International Financial Reporting Standards and for which 12 months' expected credit losses may already be covered by the SA Pillar 1 capital charge.

…

2.10 The PRA is going to collect data, as they become available, on a wider range of credit risk portfolios than in **Table A and Table B**. When the PRA has sufficient data, the PRA may develop more formal benchmarks for those portfolios.

…

2.13A Evidence indicates that IRB firms' commercial real estate (CRE) portfolios are not always comparable to SA firms' portfolios. In addition, there is significant heterogeneity between SA firms, in terms of the nature and riskiness of their CRE activities.

2.13B For the purpose of calculating a benchmark that reflects an appropriate level of risk sensitivity, the PRA encourages firms with material CRE exposures and which use the SA in relation to these exposures to assign, as part of their ICAAP, risk weights to these exposures in accordance with Table 1 of CRR Article 153(5) and the draft EBA technical standards for specialised lending.[1] The PRA's assessment of risk weights for CRE exposures will be informed by the outcome of the firm's assignation of risk weights and the quality of its assessment. The PRA will take a proportionate approach where firms' CRE portfolios are not material.

2.14 Initial analysis of the data indicates that relatively few firms would be subject to an add-on using ~~this~~the PRA's Pillar 2A credit risk methodology. Therefore, the PRA applies it on an exceptions only basis. Firms that are likely to be subject to it include, but are not limited to, those with significant exposures to sovereigns, high LTV mortgages, credit cards and CRE~~commercial real estate~~.

[1] June 2016, https://www.eba.europa.eu/-/eba-publishes-final-draft-technical-standards-on-specialised-lending-exposures

Table A Credit risk IRB benchmark

	SA RW	Exposure weighted average risk weight	Lower range RW[a]	Upper range RW[a]
Mortgages				
Prime				
0% <= LTV <50%	35.0%	~~3.3%~~ 5.3%	~~2.8%~~ 4.5%	~~3.8%~~ 6.1%
50% <= LTV <60%	35.0%	~~6.0%~~ 9.1%	~~5.1%~~ 7.7%	~~7.0%~~ 10.5%
60% <= LTV <70%	35.0%	~~8.9%~~ 11.6%	~~7.5%~~ 9.8%	~~10.2%~~ 13.3%
70% <= LTV <80%	35.0%	~~12.7%~~ 16.6%	~~10.8%~~ 14.1%	~~14.6%~~ 19.1%
80% <= LTV < 90%	36.0%	~~18.4%~~ 22.4%	~~15.6%~~ 19.1%	~~21.1%~~ 25.8%
90% < = LTV < 100%	43.0%	~~31.4%~~ 33.3%	~~29.9%~~ 28.3%	~~36.1%~~ 38.3%
>=100%		~~53.9%~~ 55.6%	~~45.8%~~ 47.2%	~~62.0%~~ 63.9%
Buy to let				
0% <= LTV <50%	35.0%	~~4.1%~~ 7.8%	~~3.5%~~ 6.6%	~~4.7%~~ 9.0%
50% <= LTV <60%	35.0%	~~9.7%~~ 11.3%	~~8.2%~~ 9.6%	~~11.1%~~ 13.0%
60% <= LTV <70%	35.0%	~~12.5%~~ 15.1%	~~10.6%~~ 12.8%	~~14.4%~~ 17.3%
70% <= LTV <80%	35.0%	~~17.5%~~ 19.2%	~~14.9%~~ 16.3%	~~20.2%~~ 22.1%
80% <= LTV < 90%	36.0%	~~32.0%~~ 39.0%	~~27.2%~~ 33.2%	~~36.8%~~ 44.9%
90% < = LTV < 100%	43.0%	~~43.1%~~ 64.8%	~~36.7%~~ 55.1%	~~49.6%~~ 74.5%
Personal loans				
Personal loans	75.0%	103.6%	88.0%	119.1%
Credit cards – revolving retail exposures				
UK credit cards	75.0%	~~107.0%~~ 120.7%	~~91%~~ 102.6%	~~123%~~ 138.8%
International credit cards	75.0%	~~168.0%~~ 175.8%	~~143%~~ 149.4%	~~193%~~ 202.2%
Corporate				
Large corporates		~~54.1%~~ 49.4%	~~46%~~ 42.0%	~~62%~~ 56.8%
Mid corporates		~~79.0%~~ 79.3%	~~67%~~ 67.4%	~~91%~~ 91.2%
SME	~~75.0%~~	~~77.7%~~ 68.5%	~~66.10%~~ 58.2%	~~89.40%~~ 78.7%
Sovereign				
High grade (CQS1)	0.0%~~[a]~~[b]	~~7.4%~~ 7.1%	~~6%~~ 6.1%	~~8%~~ 8.2%
Upper medium grade (CQS2)	20.0%	~~15.0%~~ 9.2%	~~13%~~ 7.8%	~~18%~~ 10.6%
Lower medium grade (CQS3)	50.0%	~~35.0%~~ 42.0%	~~30%~~ 35.7%	~~40%~~ 48.3%
Non-investment grade speculative (CQS4)	100.0%	~~77.0%~~ 99.8%	~~66%~~ 84.9%	~~89%~~ 114.8%
Highly speculative (CQS5)	100.0%	~~134.0%~~ 172.1%	~~114%~~ 146.3%	~~154%~~ 197.9%
Substantial risks (CQS6)	150.0%	~~220.0%~~	~~187%~~	~~253%~~
Commercial real estate				
Commercial real estate development	100%/150%[c]	~~125.0%~~	~~100.0%~~ 62.5%	~~150%~~ 350%
Commercial real estate investment	100%	~~125.0%~~	~~100.0%~~ 62.5%	~~150%~~ 350%
Institutions				
High grade (CQS1)	20.0%	~~11.5%~~ 11.1%	~~10%~~ 9.4%	~~13%~~ 12.7%
Upper medium grade (CQS2)	50.0%	~~12.0%~~ 24.1%	~~10%~~ 20.5%	~~13%~~ 27.7%
Lower medium grade (CQS3)	50.0%	~~28.0%~~ 45.8%	~~24%~~ 39.0%	~~32%~~ 52.7%
Non-investment grade speculative (CQS4)	100.0%	~~42.0%~~ 92.2%	~~36%~~ 78.4%	~~48%~~ 106.0%
Highly speculative (CQS5)	100.0%	~~90.0%~~ 140.1%	~~76%~~ 119.0%	~~103%~~ 161.1%
Substantial risks (CQS6)	150.0%	~~278.0%~~ 287.3%	~~236%~~ 244.2%	~~320%~~ 330.4%

[a] The range stated is +/- 15% and is not the simple range of IRB firms' average risk weights, with the exception of the range stated for CRE which is the full range of risk weights outlined by CRR Articles 153(5) and 158(6).

[~~a~~][b] To note, these SA risk weights would not apply to EU sovereign exposures which benefit from a 0% risk weight irrespective of their external credit rate (or CQS).

[c] As outlined by the EBA, speculative immovable property finance (including residential development) is assigned a risk weight of 150% and other CRE is assigned a risk weight of 100%.

Table B Credit risk IRB benchmark – excluding expected losses

	SA RW	Exposure weighted average risk weight	Lower range RW[a]	Upper range RW[a]
Mortgages				
Prime				
0% <= LTV <50%	35.0%	4.5%	3.9%	5.2%
50% <= LTV <60%	35.0%	7.7%	6.6%	8.9%
60% <= LTV <70%	35.0%	9.7%	8.3%	11.2%
70% <= LTV <80%	35.0%	13.9%	11.8%	16.0%
80% <= LTV < 90%	36.0%	18.7%	15.9%	21.5%
90% < = LTV < 100%	43.0%	26.4%	22.4%	30.3%
>=100%		41.0%	34.9%	47.2%
Buy to let				
0% <= LTV <50%	35.0%	6.9%	5.8%	7.9%
50% <= LTV <60%	35.0%	9.9%	8.4%	11.4%
60% <= LTV <70%	35.0%	13.2%	11.2%	15.9%
70% <= LTV <80%	35.0%	16.6%	14.1%	19.1%
80% <= LTV < 90%	36.0%	31.0%	26.3%	35.6%
90% < = LTV < 100%	43.0%	47.8%	40.6%	54.9%
Personal loans				
Personal loans	75.0%	103.6%	88.0%	119.1%
Credit cards – revolving retail exposures				
UK credit cards	75.0%	79.6%	67.7%	91.5%
International credit cards	75.0%	112.6%	95.7%	129.5%
Corporate				
Large corporates		46.3%	39.3%	53.2%
Mid corporates		71.6%	60.9%	82.4%
SME		59.9%	50.9%	68.8%
Sovereign				
High grade (CQS1)	0.0%[~~a~~][b]	7.0%	6.0%	8.1%
Upper medium grade (CQS2)	20.0%	9.1%	7.7%	10.4%
Lower medium grade (CQS3)	50.0%	40.9%	34.8%	47.0%
Non-investment grade speculative (CQS4)	100.0%	91.8%	78.0%	105.5%
Highly speculative (CQS5)	100.0%	143.1%	121.6%	164.5%
Substantial risks (CQS6)	150.0%			
Commercial real estate				
Commercial real estate development	100/150%[c]		60.0%	250%
Commercial real estate investment	100%		60.0%	250%
Institutions				
High grade (CQS1)	20.0%	10.9%	9.3%	12.5%
Upper medium grade (CQS2)	50.0%	23.7%	20.2%	27.3%

Lower medium grade (CQS3)	50.0%	44.6%	37.9%	51.3%
Non-investment grade speculative (CQS4)	100.0%	86.9%	73.9%	100.0%
Highly speculative (CQS5)	100.0%	120.0%	102.0%	138.0%
Substantial risks (CQS6)	150.0%	206.5%	175.6%	237.5%

[(a)] The range stated is +/- 15% and is not the simple range of IRB firms' average risk weights, with the exception of the range stated for CRE which is the full range of risk weights outlined by CRR Articles 153(5) and 158(6).

[(b)] To note, these SA risk weights would not apply to EU sovereign exposures which benefit from a 0% risk weight irrespective of their external credit rate (or CQS).

[(c)] As outlined by the EBA, speculative immovable property finance (including residential development) is assigned a risk weight of 150% and other CRE is assigned a risk weight of 100%.

Reporting

2.15 ~~SA firm data may be requested by supervisors on a case-by-case basis. Supervisors need to assess in advance of the Supervisory Review and Evaluation Process (SREP) whether a firm is likely to need an additional Pillar 2A credit risk add-on. If this is the case, supervisors may ask the firm to~~ Firms using the SA for credit risk for wholesale and retail credit exposures are required by Reporting Pillar 2 2.7 and 2.8 to complete the data items under the SA (FSA076 and FSA077). ~~Firms that have significant exposures to certain types of asset (eg credit cards, high LTV non-prime mortgages, zero risk-weighted sovereign exposures and commercial real estate) are more likely to be asked to submit these data than firms that do not~~.

2.16 The SA data cover a larger array of data than set out in **Table A and Table B**, in order to inform the assessment of the credit portfolios reported under the SA.

2.17 To calibrate the Pillar 2 credit risk methodology the PRA collects data. Firms with permission to use the IRB approach for retail exposures are required by Reporting Pillar 2 2.5 to submit data on retail exposures. Firms that are in scope are required to submit the data with their Internal Capital Adequacy Assessment Process (ICAAP) submissions. Significant firms with permission to use the IRB approach must submit the data annually in any event. 'Significant firm' means a deposit-taker or designated investment firm whose size, interconnectedness, complexity and business type give it the capacity to cause very significant disruption to the UK financial system (and through that to economic activity more widely) by failing or by carrying on its business in an unsafe manner.

Appendix 2: Draft amendments to Supervisory Statement 31/15 – The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)

This appendix outlines proposed amendments to SS31/15. Underlining indicates new text and striking through indicates deleted text.

…

5 The SREP

…

5.12 The PRA will set ICG in light of both the calculations included in a firm's ICAAP and the results of the PRA's own Pillar 2A methodologies. Setting ICG is subject to peer group reviews to ensure consistency of decisions across firms.

5.12A For firms using the standardised approach (SA) for credit risk, the PRA will assess whether the capital held by them exceeds the amount necessary to ensure a sound management and coverage of their risks. To this end, the PRA will make an overall assessment of the adequacy of capital, taking into account the outcome of the application of the PRA's own Pillar 2A methodologies, the firm's ICAAP, business model, and whether the firm is considered relatively low-risk and well-managed. The PRA will also conduct a peer group review, including with those firms that use the IRB approach, by using the upper range of the credit risk IRB benchmarks which are set out in 'Statement of Policy - The PRA's methodologies for setting Pillar 2 capital'.

5.12B Following this, the PRA will calculate the level of capital that is necessary, in addition to the capital the firm must hold to comply with the CRR (Pillar 1), to capture risks to which the firm is or might be exposed. This may lead to the PRA adjusting the firm's Pillar 2A add-ons, as assessed in accordance with the PRA's own methodologies, downward, taking into consideration how firms' capital relates to the IRB benchmarks considered as part of the peer review. The comparison to the benchmarks is not mechanistic and will depend on the extent to which it reflects firm-specific risk profiles.

5.12C For firms using International Financial Reporting Standard 9, the PRA will also consider the extent to which expected credit losses, over a twelve month period, are covered by the Pillar 1 charge under the SA, to inform the setting of ICG.

5.13 The PRA will review the firm's records referred to in Internal Adequacy Assessment 13.1 as part of its SREP to judge whether a firm will be able to continue to meet its CRR requirements and the overall financial adequacy rule in Internal Capital Adequacy Assessment 2.1 throughout the time horizon used for the capital planning exercise.

…

Appendix 3: Draft amendments to Supervisory Statement 32/15 'Pillar 2 reporting, including instructions for completing data items FSA071 to FSA082'

This appendix outlines proposed amendments to SS32/15 and the Pillar 2 Reporting schedule.

Underlining indicates new text and striking through indicates deleted text.

…

2 Reporting Pillar 2

…

2.5 Firms may be asked to submit, on a case-by-case basis, further data where these are necessary to inform the PRA's Pillar 2 methodology and supervision of the firm. This may include:

- data on operational risk from firms that are not significant firms and are using a standardised approach to calculate their Pillar 1 capital requirement for operational risk;
- more granular pension risk data of the kind needed for FSA081 from all firms~~;~~.
- ~~data items FSA076[1] and FSA077[2] for credit risk. This is likely to occur where a supervisor judges that the standardised approach may underestimate credit risk. For example, this might include firms with significant exposures to sovereigns, high loan to value non-prime mortgages, credit cards and commercial real estate.~~

…

FSA076 Pillar 2 Credit risk standardised approach wholesale

All firms should complete this data item for all wholesale portfolios for which capital requirements are calculated using the standardised approach for credit risk.~~, based on ad hoc request by supervisors, as set out in Section 1(2) of the statement of policy on Pillar 2. The PRA expects to ask firms to submit these data where it is likely that the standardised approach for credit risk underestimates risk. Firms that are likely to be subject to this expectation include, but are not limited to, those with significant exposures to sovereigns, high LTV mortgages, credit cards and commercial real estate.~~

…

FSA077 Pillar 2 Credit risk standardised approach retail

…

[1] ~~FSA076 is available at www.bankofengland.co.uk/pra/Documents/crdiv/fsa076.xls.~~
[2] ~~FSA077 is available at www.bankofengland.co.uk/pra/Documents/crdiv/fsa077.xls.~~

All firms should complete this data item for all retail portfolios for which capital requirements are calculated using the standardised approach for credit risk.~~, based on ad hoc request by supervisors, asset out in Section 1(2) of the statement of policy on Pillar 2. The PRA expects to ask firms to submit these data where it is likely that the standardised approach for credit risk underestimates the risk. Firms that are likely to be subject to this expectation include, but are not limited to, those with significant exposures to sovereigns, high LTV mortgages, credit cards and commercial real estate.~~

...

Pillar 2 Reporting schedule

Data items	Scope of population(*)	Group/individual entities	Reporting period/submission deadlines	Reporting frequency
Credit Risk Standardised Approach data items FSA076 - Pillar 2 Credit Risk Standardised Approach Wholesale FSA077 - Pillar 2 Credit Risk Standardised Approach Retail	Firms using the Standardised approach on all or part of their books~~, on request~~	On an individual or consolidated basis in accordance with Pillar 2 Reporting 2.7-2.8 ~~as requested~~; individual entities within a group on a case-by-case basis	In conjunction with ICAAP submission dates	~~On request~~ Significant firms annually; others on a regular and proportionate basis

(*) The PRA may ask other firms to submit the data on a case-by-case basis

Appendix 4: PRA Rulebook: CRR FIRMS: Reporting Pillar 2 Amendment No. 1 Instrument 2017

Powers exercised

A. The Prudential Regulation Authority ("PRA") makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):

(1) section 137G (The PRA's general rules); and

(2) section 137T (General supplementary powers).

B. The rule-making powers referred to above are specified for the purpose of section 138G(2) (Rule-making instrument) of the Act.

Pre-conditions to making
C. In accordance with section 138J of the Act (Consultation by the PRA), the PRA consulted the Financial Conduct Authority. After consulting, the PRA published a draft of proposed rules and had regard to representations made.

PRA Rulebook: CRR Firms: Reporting Pillar 2 Amendment No. 1 Instrument 2017
D. The PRA makes the rules in the Annex to this instrument.

Commencement
E. This instrument comes into force on 1 January 2018.

Citation
F. This instrument may be cited as the PRA Rulebook: CRR Firms: Reporting Pillar 2 Amendment No. 1 Instrument 2017.

By order of the Board of the Prudential Regulation Authority
[DATE]

Annex

Amendments to the Reporting Pillar 2 Part of the PRA Rulebook

In this Annex, new text is underlined and deleted text is struck through.

…

1 APPLICATION AND DEFINITIONS

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1.6 In this Part the following definitions shall apply:

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Standardised Approach to credit risk

means the approach to credit risk set out in Chapter 2 of Title II of *CRR*;

…

2 PILLAR 2 REPORTING REQUIREMENTS

…

2.7 A *firm* must complete the *data item* FSA076 for any wholesale portfolio of exposures for which capital requirements are calculated using the *Standardised Approach to credit risk*.

2.8 A *firm* must complete the *data item* FSA077 for any retail portfolio of exposures for which capital requirements are calculated using the *Standardised Approach to credit risk*.

…

4 DATA ITEMS

…

4.11 FSA076 can be found here.

4.12 FSA077 can be found here.

Appendix 5: Reporting templates FSA076 and FSA077

Draft template	Available at:
FSA076	http://www.bankofengland.co.uk/pra/Documents/crdiv/fsa07620160205.xltx
FSA077	http://www.bankofengland.co.uk/pra/Documents/crdiv/fsa07720160205.xltx