

Policy Statement | PS2/20

Pillar 2 Capital: Updating the Framework

January 2020



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PRUDENTIAL REGULATION
AUTHORITY





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1 Overview

1.1 This Prudential Regulation Authority (PRA) Policy Statement (PS) provides feedback to responses to Consultation Paper (CP) 5/19 'Pillar 2 capital: Updates to the framework'.¹ This PS contains the final amendments to the Pillar 2 framework and updates to the following Statement of Policy (SoP) and supervisory statements (SS):

- SoP 'The PRA's methodologies for setting Pillar 2 capital' (Appendix 1)
- SS31/15 'The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)' (Appendix 2); and
- SS6/14 'Implementing CRD IV: Capital buffers' (Appendix 3).

1.2 This PS is relevant to PRA-authorised banks, building societies and PRA-designated investment firms (firms). It is not relevant to credit unions, insurance and reinsurance firms.

Background

1.3 In CP5/19 the PRA proposed to update the Pillar 2 capital framework to reflect continued refinements and developments in setting the PRA buffer (also referred to as Pillar 2B). The CP made proposals in five areas:

- the hurdle rate in stress
- buffer interactions and usability
- the risk management and governance assessment
- updating benchmarks for assessing Pillar 2A credit risk; and
- minor corrections to drafting.

Summary of responses

1.4 The PRA received five responses to CP5/19. Respondents sought further clarification on setting the PRA buffer using the hurdle rate in stress, buffer interactions and usability.

Changes to draft policy

1.5 Following consideration of the respondents' comments, the PRA has made some minor changes to the proposals. The PRA has updated the SoP to clarify that:

- in general, the PRA will use the leverage exposure measure as the single scaling base for the operational risk and interest rate risk in the banking book (IRRBB) Pillar 2A components of the hurdle rate in stress because the PRA considers it to be a more robust and representative scaling base. This has been clarified in Table E - 'Pillar 2A scaling bases'
- in setting the PRA buffer, factors in addition to a firm's hurdle rate(s) will be considered. These include, but are not limited to: the firm's leverage ratio; Tier 1 and total capital ratios; risks

¹ March 2019: <https://www.bankofengland.co.uk/prudential-regulation/publication/2019/pillar-2-capital-updates-to-the-framework>.

associated with double leverage; and the extent to which potentially significant risks are not captured fully as part of the stress test. This is set out in paragraph 9.44

- the purpose of the PRA buffer and its interaction with the combined buffers is set out in paragraph 9.1 and 9.28-9.31
- in general, the PRA takes the approach of using risk weighted assets (RWAs) at the start of the stress and that this may be adjusted to reflect changes to the balance sheet as set out in paragraph 9.32
- the example illustrating the process of calculating the PRA buffer is a stylised example and does not represent an exhaustive scenario as set out in paragraph 9.32.

1.6 In addition to the changes above, the PRA has decided to add a reference in SS31/15, paragraph 2.41, to its existing policy on managing climate-related financial risks.

1.7 The PRA has made no changes to the draft policy for SS6/14.

1.8 The changes are explained in Chapter 2. The PRA does not consider these changes significant enough to have any additional material impact on the costs or benefits on firms or mutuals, and so has not provided an updated cost-benefit analysis.

Implementation

1.9 The changes in this PS take effect from publication date on Thursday 23 January 2020.

1.10 The policy set out in this PS 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.

1.11 In the event that the UK leaves the EU with no implementation period in place, the PRA has assessed that the policy would not need to be amended under the EU (Withdrawal) Act 2018 (EUWA). Please see PS5/19 'The Bank of England's amendments to financial services legislation under the European Union (Withdrawal) Act 2018'² for further details.

1.12 The final Ss and SoP attached to this PS should be read in conjunction with SS1/19 'Non-binding PRA materials: The PRA's approach after the UK's withdrawal from the EU'.³

² April 2019: <https://www.bankofengland.co.uk/paper/2019/the-boes-amendments-to-financial-services-legislation-under-the-eu-withdrawal-act-2018>.

³ February 2019: <https://www.bankofengland.co.uk/prudential-regulation/publication/2019/non-binding-pra-materials-the-pras-approach-after-the-uks-withdrawal-from-the-eu-ss>.

2 Feedback to responses

2.1 The PRA has considered the responses received on the CP. This chapter sets out the PRA's feedback to those responses, and its final decisions.

2.2 This section sets out specific areas where the PRA has adjusted or clarified the proposals. It has been structured broadly along the same lines as the chapters of the CP:

- the hurdle rate in stress
- buffer interactions and usability
- the PRA buffer setting process
- responses outside of the scope of the CP; and
- additional clarifications that the PRA has made.

The hurdle rate in stress

2.3 In CP5/19, the PRA proposed a new approach for including Pillar 2A in the hurdle rate. The new approach was designed to better reflect the evolution of Pillar 2A over time in the stress test through scaling each Pillar 2A risk component with an appropriate base.

Scaling bases

2.4 Two respondents requested changes to the scaling bases used for Pillar 2A components in a stress. One respondent suggested that the PRA should commit to a single scaling base for every component ahead of the stress test, and the other suggested that operational risk be scaled to the leverage exposure measure.

2.5 The PRA has assessed the appropriateness of the scaling bases in response to these suggestions. The PRA considers that the leverage exposure measure is a more robust and representative scaling base for operational risk and IRRBB. The PRA considers that the total assets measure can be volatile, making it less useful.

2.6 As a result, the PRA will, in general, use the leverage exposure measure as the single scaling base for operational risk and IRRBB. The PRA clarifies this with an update to Table E – 'Pillar 2A scaling bases' in the SoP.

2.7 The PRA anticipates that this clarification with its focus on one measure will provide greater certainty for a firm's own stress testing and capital planning. Given this clarification to the SoP, the PRA considers that it is not necessary to confirm the scaling base ahead of stress testing.

2.8 One respondent requested that institutions subject to stress testing should be able to model pension risk as a part of their assessment of the stress hurdle rate.

2.9 The PRA expects firms to quantify the pension surplus or deficit in stress. However, the PRA does not expect firms to model their Pillar 2A pension risk add-on as an input to their hurdle rate. This calculation would involve several layers of judgement and be excessively complex. The PRA's approach to projecting the pension risk Pillar 2A add-on in stress therefore remains unchanged.

Capital quality

2.10 One respondent sought clarification over whether hurdle rates are applicable only for common equity tier 1 (CET1), or also for other tiers of capital.

2.11 The PRA applies two types of hurdle rates: one based on the CET1 share of RWAs and the other based on the Tier 1 leverage ratio measure. In setting the PRA buffer other factors will be considered in addition to a firm's hurdle rate(s). These include, but are not limited to: the firm's leverage ratio; Tier 1 and total capital ratios; risks associated with double leverage; and the extent to which potentially significant risks are not captured fully as part of the stress test. This is set out in paragraph 9.44 of the SoP.

Buffer interactions and usability

2.12 In CP5/19, the PRA proposed to clarify the interaction between the PRA buffer and the combined buffers.⁴ As a part of that, the CP included a new illustration of the capital stack that more accurately reflects the framework. The PRA also proposed revised language to clarify that the PRA buffer can be used to absorb losses in a stress.

The PRA buffer and the countercyclical capital buffer

2.13 One respondent had understood that the PRA buffer was additive to the capital conservation buffer (CCoB) but not the countercyclical capital buffer (CCyB) and requested examples for clarity.

2.14 The PRA's proposals in CP5/19 sought to clarify its existing approach to setting the PRA buffer and were not a reflection of new policy. The PRA sets the PRA buffer taking applicable buffers into account, as well as the annual stress test (AST) and any other stress tests carried out. The final PRA buffer is additive to the relevant CCyB. Changes in the CCyB⁵ will generally be additive to firms' existing PRA buffers. This is illustrated in the stylised example in paragraphs 9.32-9.33 in the SoP. Any change in the CCyB rate set by the Financial Policy Committee (FPC) does not result in an immediate change to the PRA buffer.

Definition of the PRA buffer

2.15 One respondent requested further clarification of the definition of Pillar 2B and the PRA buffer, suggesting that new entrants may be confused. The PRA considers that the updated drafting of Chapter 9 of the SoP clarifies that the terms 'Pillar 2B' and the 'PRA buffer' can be used interchangeably to describe the amount of capital that firms should hold in addition to their total capital requirements and the combined buffer. The PRA considers that the updated drafting should improve understanding among market participants.

2.16 One respondent suggested that the existing capital stack illustration⁶ should be retained. The PRA considers that the new illustration, proposed in CP5/19, better reflects the PRA's approach to setting the PRA buffer than the original. The new illustration does not reflect any changes to policy, but is a clarification of the PRA's existing approach. The PRA does not propose changes to the SoP.

⁴ The combined buffer comprises the capital conservation buffer (CCoB), the countercyclical capital buffer (CCyB), the buffer for global and other systemically important institutions (G-SIIs and O-SIIs) and (for ring-fenced banks and the largest building societies) the Systemic Risk Buffer (SRB).

⁵ The PRA buffer is composed of: the stress impact, the risk management and governance scalar and supervisory judgement. The stress impact is calculated as the reduction in CET1 capital headroom (shortfall) in a severe but plausible stress. The size of the PRA buffer is calculated as the stress impact net of the CCoB and the CCyB. The CP clarified that the PRA buffer will be a positive where the stress impact is greater than the sum of CCoB and CCyB. For example where the CCoB is 2.5% and the CCyB is 1%; the PRA buffer will be positive where the stress impact is greater than 3.5% (the calculation is independent of the size of the governance scalar and supervisory judgement).

⁶ See figure 2, page 35, SoP, April 2018: <https://www.bankofengland.co.uk/prudential-regulation/publication/2015/the-pras-methodologies-for-setting-pillar-2-capital>

The PRA's approach to buffer usability

2.17 Two respondents suggested that the PRA should add further information on the usability of the PRA buffer. In particular, to detail the circumstances under which firms may use the PRA buffer and the PRA's approach to its use. The respondents suggested firms had built up excess capital to avoid use of their PRA buffer.

2.18 The PRA considers that the proposed text in CP5/19 clarifies the PRA's view that the PRA buffer (as well as all capital buffer) is usable in a stress and the PRA does not expect firms to maintain additional capital to avoid using the PRA buffer or combined buffers in a stress. Where the PRA buffer is used to absorb losses in a stress, the PRA will be content for firms to rebuild their buffers over a reasonable period. The PRA will take into account the amount by which the buffer has been used, the type of stress experience and its expected duration. In the CP, the PRA notes that the PRA buffer should not be used in the normal course of business or as part of the firm's base business plan. The PRA has decided not to change the draft of the SoP.

The PRA buffer setting process

2.19 In CP5/19, the PRA proposed to illustrate the PRA buffer setting process through a stylised example. The PRA received comments relating to: the use of RWAs to set the PRA buffer; management actions; the accuracy of the numerical example; the capital composition of the hurdle rate; and a request to add further detail to the example.

Calculating the PRA buffer

2.20 One respondent sought clarification on how RWAs are used when calculating the PRA buffer.

2.21 The PRA derives the stress test impact in absolute terms and then expresses that as a percentage of the firm's RWAs. The PRA generally takes the approach of using RWAs as at the start of the stress. The PRA may apply adjustments to RWAs to reflect changes to the balance sheet. This is clarified in the SoP in paragraph 9.32.

Stylised example

2.22 One respondent sought clarification on how management actions are reflected in the example in CP5/19.

2.23 As stated in the SoP (paragraph 9.24 and 9.25), in setting the PRA buffer the PRA recognises management actions that firms could and would realistically take to mitigate the impact of the stress scenario. When considering the viability of the management actions, the PRA will consider the:

- credibility of the actions in hypothetical stressed market conditions
- effects on the firm's reputation
- risks with executing the actions
- time to implement the actions; and
- whether there is a proven track record of the applying the management actions.

2.24 Further guidance on management actions is provided in SS31/15. The stylised example includes the key information, but does not represent all factors considered in assessing the stress impact. This is clarified in the SoP in paragraph 9.32.

2.25 One respondent questioned the accuracy of using 0.5% CCyB, instead of the current rate of 1% set by the FPC in the example, and noted a rounding point. The CCyB rate was given as an example only; it is not fixed and can change in response to changes in financial conditions. The example did not include the exact numbers from the calculations. The PRA has reflected the rounding in paragraph 9.33 in the SoP.

2.26 One respondent requested further explanation in the example on the composition of the hurdle rate and CET1 capital.

2.27 In CP5/19 the PRA proposed to clarify that a firm's hurdle rate is the level of CET1 capital it is expected to maintain in a severe but plausible stress. For all firms not participating in the AST, the hurdle rate is equal to total capital requirements (TCR). For firms participating in the AST, the hurdle rate is specified in stress test guidance published on the Bank's website.⁷ CET1 capital may also be required to cover any shortfalls in Additional Tier 1 (AT1) or Tier 2 (T2) capital before it can count towards the combined buffer, the PRA buffer or be considered excess. The diagram proposed in CP5/19 is a stylised example to show how the PRA buffer is calculated. The PRA does not propose further changes to the example.

Outside of the scope of the CP

2.28 The remaining responses went beyond the scope of CP5/19.

2.29 One respondent encouraged further dialogue between the PRA and market participants around the impact of forthcoming regulatory change. The PRA welcomes this comment and will continue to maintain a dialogue with firms.

2.30 One respondent suggested that Pillar 2 capital should work as an insurance structure, with capital resources injected automatically as an unexpected loss event materialises, under terms and conditions defined ex ante. The PRA welcomes the information, but will not be making changes to its approach at this time.

Additional Clarifications

Enhancing banks' approaches to managing the financial risks arising from climate change

2.31 In April 2019, the PRA published SS3/19 'Enhancing banks' and insurers' approaches to managing the financial risks arising from climate change'.⁸ In SS3/19, the PRA set out its expectation that firms understand the financial risks from climate change and how they will affect their business model. Firms are expected to include what they determine to be any material exposures relating to the financial risks from climate change in the ICAAP. This should include how firms have determined what constitutes a material exposure in the context of their business.

2.32 Firms should also use scenario analysis and stress testing to inform the risk identification process and to understand the short- and long-term financial risks to their business model from climate change. Firms are also expected to go beyond using only historical data to inform their risk assessment. The PRA expects that such scenarios will develop and mature over time as firms learn from experience and each other.

⁷ The hurdle rate reflects the level of capital firms are expected to maintain in a stress. This is specific to each stress test. Firms participating in the AST should refer to the guidance for each test: <https://www.bankofengland.co.uk/stress-testing>.

⁸ April 2019: <https://www.bankofengland.co.uk/prudential-regulation/publication/2019/enhancing-banks-and-insurers-approaches-to-managing-the-financial-risks-from-climate-change-ss>.

2.33 The PRA will add a link to the expectations in SS31/15 in order to consolidate the PRA's expectations for ICAAPs in paragraph 2.42. This addition does not introduce new policy or change existing policy.

Appendices

- 1 Statement of Policy 'The PRA's methodologies for setting Pillar 2 capital', available at:
<https://www.bankofengland.co.uk/prudential-regulation/publication/2015/the-pras-methodologies-for-setting-Pillar-2-capital>

 - 2 SS31/15 'The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)', available at:
<https://www.bankofengland.co.uk/prudential-regulation/publication/2013/the-internal-capital-adequacy-assessment-process-and-supervisory-review-ss>

 - 3 SS6/14 'Implementing CRD IV: Capital buffers', available at:
<https://www.bankofengland.co.uk/prudential-regulation/publication/2014/implementing-crdiv-capital-buffers-ss>
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