BANK OF ENGLAND

Speech

“Harrowing the ploughed field” – Refining the standardised capital regime

Speech given by

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Much has been written on the evolution of UK retail banking post the financial crisis and a recurrent theme has been the difference between the internal ratings based (IRB) capital approach used by the major UK banks and building societies and the standardised capital approach used by the mid-tier and smaller firms. When comparing the capital regimes, an “un-level playing field sloping in favour of the major firms”, seems to be the common analogy that is used. There are some differences of opinion as to the steepness of the slope, ranging from a gentle hill, to others claiming firms using the standardised capital regime have a mountain to climb.

The post-financial crisis prudential reforms were necessary and have done a lot to improve the resilience of the UK banking sector. However, regulation can lead to unintended consequences and, where appropriate, the PRA will always seek to address these. To that end, the PRA has undertaken in-depth research over the last two years into the differences between the capital regimes and today I would like to set out our conclusions and response.

The primary conclusion from our research is that we agree that the regulatory reforms have had the unintended consequence of contributing to an un-level playing field. However, we disagree that the playing field slopes uniformly in favour of the major firms; to continue with the analogy, it can probably be best described as a ploughed field. Our analysis points to ridges and furrows being created, some ridges favour those firms using IRB models and others favour those on the standardised capital approach.

So how do we tackle this ploughed field? For those of you that are not city dwellers, you will know that if you want to prepare a ploughed field for crops to flourish, you first of all need to harrow it, to smooth out the ridges and furrows ready for planting.

As the first findings of our research emerged, we acted to smooth some of the most significant ridges by implemented, at the beginning of 2016, a binding leverage constraint on the major banks and building societies using IRB models. We always recognised that this would not be sufficient on its own and we have embarked on three further initiatives to harrow the capital field.

Firstly, we have been working at the Basel Committee to create greater risk sensitivity in the standardised capital approach, which should reduce the variability between standardised and IRB risk weights.

Secondly, we are proposing to refine the PRA’s Pillar 2A capital framework for banks and building societies using the standardised capital approach and we published a consultation paper on 24 February setting out our thinking in this area.

Thirdly, we propose to reform the application process for banks and building societies wanting to move from the standardised capital approach to utilise IRB models and today I am announcing that we will be publishing a consultation paper later this month on this initiative.

Why are we undertaking these three initiatives? The PRA has a primary objective to maintain the safety and soundness of firms it regulates, and capital regimes that create risk concentrations in groups of firms are not aligned with this objective and need to be addressed. The PRA's secondary objective is to facilitate effective competition in the markets for services provided by PRA-authorised firms and in our judgement effective competition is currently being distorted by the differences in the capital regimes.

May I focus on residential mortgage lending to illustrate the impact of the different capital regimes. For banks and building societies operating on the standardised capital approach, the risk weight for residential mortgage lending is 35% for all lending up to a loan to value of 80%. It is static with no other underwriting factors being taken into consideration. For the banks and building societies operating IRB models, the risk weight will be dynamic influenced by a variety of risk factors which include loan to value and loan to income. The risk weights generated by these models start significantly below 35% and rise as the risk factors increase. The consequence of a static and dynamic risk weight under the different capital regimes is to create points of risk concentration, at low LTV lending for firms the using IRB models and at high LTV and high LTI for firms on the standardised capital approach.

As the cost of capital is a major component in mortgage pricing models, these risk concentrations impact on the mortgage market, with a cohort of lenders competing in one segment, another cohort competing in a different segment and some market segments being poorly served.

We have identified that there are ploughed fields of ridges and furrows in many lines of business across UK retail banking, not just residential mortgage lending and to harrow these will require all three of our initiatives, which I would like to address in turn:

Working at the Basel Committee

The Basel Committee first consulted on revising the standardised approach for credit risk in December 2014 and following the feedback it received, further consulted in December 2015, with the aim of publishing its final proposals at the end of 2016. The PRA and the Bank has been very actively engaged at Basel throughout these consultations, ensuring our research into the differences between the capital regimes in the UK market was fully considered in the global debate. We were clear that greater risk sensitivity was required in the standardised approach for credit risk and this had to be combined with some constraints being applied to the IRB capital models, to ensure the ploughed field was harrowed.

Some commentators badged this work as Basel IV. I want to take this opportunity to emphasise that the PRA does not see these revisions as a fundamental new Basel regime. Rather they are completing a key part of the post crisis Basel III reforms, tacking unwarranted risk weighted asset variability and doing so in a way that does not significantly increase system-wide capital requirements. The work at Basel was very much focused on harrowing the ploughed field, not re-ploughing it to create a new Basel regime.

It has not yet been possible for the Governors and Heads of Supervision to announce the framework's final calibration and we will continue to encourage all members of the Basel Committee to find common ground in this work.

Refining the PRA's Pillar 2A capital framework for banks and building societies on the standardised capital approach

On 24 February the PRA published a Consultation Paper CP3/17 setting out our proposals for refining the Pillar 2A capital framework for firms using the standardised capital approach for credit risk. Why do we consider this is required? We are concerned that the current risk insensitivity of standardised risk weights, coupled with a mechanistic approach to calculating Pillar 2A capital, can be a primary contributor to creating the ploughed field and this concern has also been shared by the Competition and Markets Authority in its retail banking market investigation that concluded in August 2016.

When a bank or building society undertakes its annual Internal Capital Adequacy Assessment Process (ICAAP) it is making its own assessment of the total quantum of capital it considers to be adequate to cover the level and nature of risks to which it is exposed or could be exposed in a stress event. This is expressed in terms of pillar 1 capital, Pillar 2A capital and in its pillar 2b capital buffers. This assessment is shared with the PRA and we hold a Supervisory Review and Evaluation Process (SREP) to formulate our judgement on the ICAAP. We then notify the firm of the quantum of capital that it should hold at all times and its capital buffers to ensure that it is able to meet its minimum requirements in a severe but plausible stress.

We are concerned that the mechanistic use of our published Pillar 2A methodologies, coupled with standardised risk weights can result in a bank or building society, that is well managed and undertaking mainstream (not niche) lending, holding in total too much regulatory capital, relative to the risks on its balance sheet. But how do we quantify the degree of this potential over capitalisation? Our proposed approach is to publish credit risk benchmarks, derived from the banks deploying IRB models. These benchmarks are not new, we first published these in 2015, we updated them on 24 February and we will update them annually in future years.

Under the proposals in CP 3/17, we would expect firms to demonstrate in their ICAAPs the degree to which their business model is low risk and the appropriate level of total capital, given their business mix. This may include taking into account the higher degree of conservatism that may apply to certain asset classes under the standardised approach, using the credit risk benchmarks as the reference point for this judgement. A firm's board may then conclude that it is appropriate for them to hold less Pillar 2A capital.

The PRA's SREP will consider whether the use of the credit risk benchmarks is appropriate, primarily focusing on whether a bank or building society is well managed and in our judgement operating in the mainstream markets from where the benchmarks are derived. Where we concur that the use of the benchmarks is appropriate this will also inform our judgement to reduce Pillar 2A capital.

This “refined” approach to assessing overall regulatory capital requirements, informed by credit risk benchmarks is a significant change to our approach and we welcome responses to CP3/17, to enable us to publish our final policy statement later this year.

In publishing this consultation paper we are also tackling concerns that the introduction of accounting standard IFRS9 on 1 January 2018 could further exacerbate the difference between the standardised capital approach and IRB models. To mitigate this emerging risk, we are proposing to publish different credit risk benchmarks for firms operating on UK GAAP and IFRS to ensure that new ridges and furrows are not created as a consequence of different accounting standards.

Reforming the application process for banks and building societies wanting to move from the standardised to using IRB models

Running IRB models does require a significant additional investment in risk infrastructure for banks and building societies wishing to move from the standardised capital approach. Through our work at Basel and refining the Pillar 2A capital framework, the PRA’s objective is to ensure we have an approach that harrows the ploughed field for firms using the standardised capital approach and therefore reduces the incentive for all firms to make this investment. However, we acknowledge that the impact of the IFRS9 accounting standard, coupled with the requirement for some banks and building societies to hold additional financial resources, to ensure they are resolvable, that is over and above total regulatory capital requirements, may now justify the investment, when previously the business case could not be made.

Our research into transitioning from the standardised capital approach to using IRB models, which we published in the PRA’s 2016 Annual Competition Report, indicated that there were 3 significant issues firms faced when making the step:

1. Clarity of the PRA’s expectations in respect of our requirements to permit the use of IRB models.
2. Understanding of the PRA’s assessment process.
3. Data inadequacies.

At the end of this month, we will be consulting on revising our Internal Ratings Based Supervisory Statement first published in 2013 (SS11/13). I must reinforce that the revisions are not about lowering standards, which must be maintained to ensure regulatory requirements are robust, and the PRA will remain consistent in its assessment methodologies for all IRB frameworks, whether they are being deployed by a global bank or a UK residential mortgage lender.

Our work will go beyond publishing a consultation paper.

Firstly, to improve the clarity of our expectations, we will publish extensive information on our website and engage with firms in the pre-application process. This will very much mirror the approach we have adopted for new banking applications. I must be clear, the PRA will not be acting as a consultant, nor provide pre-approval but we will ensure that all firms have the opportunity to discuss our expectations and idiosyncratic issues before submitting their application.

Secondly, we will propose extensive revisions to our assessment process, into ten modules, so that a firm is clear where it is at all times within our assessment work. These modules will start with scoping, then a technical review, examination of underlying data, before moving on to the use test. Modules five to eight will assess partial use and roll-out plans, reporting, independent validation and governance. Module nine will involve the PRA bringing all of its work together to set out a preliminary recommendation, before moving to module ten - approval. We do acknowledge that we may sometimes require firms to undertake some remediation actions when we issue our preliminary recommendation, with the requirement for these to be completed before we can give final approval.

A key part of our consultation will set out our proposed approach to address the difficulty in building up data points for IRB models in the current economic environment. This is a considerable issue for both new and some established firms, particularly as loss given default requires not only default data but also subsequent possession information. We found that the time taken to model loss given default can become the greatest constraint in the evolution of a firm’s IRB models and supporting framework. We will be setting out our expectations for banks and building societies who in developing IRB models for residential mortgages want to augment limited internal data with external data sources, and how additional margins of conservatism will need to be overlaid on the external data.

Our aim in the upcoming consultation paper is to address the “data conundrum” considered to be an unsurmountable issue faced by some banks and building societies wishing to use IRB models.

Conclusion

So may I conclude by bringing us back to our field. The analysis the PRA has undertaken over the last two years challenges the widely held opinion that the playing field is uniformly sloping in favour of the major banks using IRB models. We should view the field as ploughed, with ridges and furrows of risk concentrations. The PRA is committed to harrow the ploughed field. We will continue to work through the Basel Committee to create greater risk sensitivity in the standardised capital approach. We would encourage banks and building societies to respond to our 24 February consultation paper on the Pillar 2A capital regime and the upcoming consultation paper, to be published later this month, setting out our proposed revisions to our previous supervisory statement on IRB models and frameworks. This will enable us to take onboard your feedback and publish policy statements later this year that establish a field where both banks and building societies using IRB models and the standardised capital approach can flourish.