

In the detail

PRA proposals on Pillar 2 capital requirements



The PRA's [consultation paper](#) on Pillar 2 capital requirements sets out a series of proposed changes to the PRA's Pillar 2 framework.

The consultation period runs to 17 April and the new framework will be implemented from 1 January 2016.

Why change?

The UK regulators have for a long time (dating back to when the Bank of England was responsible for banking supervision before 1998) imposed Pillar 2 capital requirements on banks on an individual bank basis, to reflect risks to a bank that are not captured (or not fully captured) under Pillar 1 capital requirements (Pillar 2A), and risks to which the bank may become exposed in the future (Pillar 2B).

As already announced by the PRA in December 2013, at least 56% of Pillar 2A capital requirements should be held in CET1 capital, and all Pillar 2B capital charges should be held as CET1 capital.

The proposed changes are driven primarily by the CRR revisions to the Pillar 1 requirements, and by the EBA's December 2014 Guidelines on the Supervisory Review and Evaluation Process (SREP). The proposals also reflect a move to a more risk-sensitive approach, which is applied more consistently and more transparently across banks.

The consultation does not cover the additional minimum requirements for own funds and eligible liabilities (MREL) under the Banking Recovery and Resolution Directive (BRRD).

Revised methodologies for Pillar 2A capital

The consultation paper sets out revised methodologies for some elements of Pillar 2A capital.

1. Credit risk

For banks on the standardised approach (or with a significant share of their credit exposures remaining on the standardised approach), the PRA will compare the standardised approach (SA) calculation of risk weighted assets (RWAs) with a calculation of RWAs using a series of more granular benchmarks derived from the risk weightings applied by banks using internal ratings-based models. These benchmark risk weightings apply a higher risk weight than the SA risk weight to riskier credit exposures within each risk class.

The methodology also allows positive capital charges on some asset classes to be offset by negative charges on other asset classes (although the overall credit risk Pillar 2 requirement cannot be negative).

The benchmark risk weights on prime residential mortgages would range from 3.3 percent (for loan to value ratios below 50 percent) to 53.9% (for LTVs above 100 percent). These benchmark risk weights are considerably lower than the SA risk weights until LTVs exceed 100 percent. However, in some other asset classes, such as credit cards and commercial real estate, the benchmark risk weights are higher than the SA risk weights.

So a zero Pillar 2 capital requirement for credit risk would be applied to a specialist mortgage lender using the SA, unless it had a large volume of mortgages with an LTV above 100 percent. For more diversified banks the overall Pillar 2 credit risk requirements would depend on (a) the distribution of their lending across asset classes, (b) the riskiness of their lending within each asset class, and (c) the net effect of any positive and negative results across asset classes.

2. Credit concentration risk

The proposed methodology for credit concentration risk is to calculate concentration indices for single name exposures, sector exposures and geographic exposures, and then to apply capital requirements to each of these concentrations, using a sliding scale depending on the extent of each of these types of credit concentration risk.

So single name concentration would attract a Pillar 2 requirement of 0-4 percent (of risk weighted assets within the relevant portfolio), sector concentration 0-2.8 percent, and geographic concentration 0-1.4 percent.

Perhaps surprisingly, all retail lending is excluded from the sector concentration calculation, and residential mortgage portfolios on the SA are excluded from the geographic concentration calculation. This should reduce credit concentration risk Pillar 2 capital requirements on mortgage lenders, especially those on the SA approach, although this is not highlighted in the PRA's cost benefit analysis.

3. Operational risk

For banks not using the advanced measurement approach (AMA), the PRA will set Pillar 2 capital requirements for operational risk on a judgemental basis.

For non-conduct risk this will be based on a comparison of the Pillar 1 charge against loss estimates based on:

- a. A bank's expected losses due to operational risk using a 99.9 percent confidence interval;
- b. A bank's actual losses over the last five years in the event class giving rise to the highest losses; and
- c. A bank's stressed scenarios for operational risk impacts.

For conduct risk, this will be based on a bank's largest conduct losses over the last five years, expected conduct risk losses, and conduct-related stressed scenarios.

4. Pension obligation risk

Pension obligation risk relates to defined benefit pension schemes and defined contribution schemes offering guaranteed returns that are not fully matched by underlying investments. Some of this risk is already captured under Pillar 1 requirements, since the accounting deficit of a bank's pension scheme is deducted from Common Equity Tier 1 (CET1) capital.

Banks are exposed to pension obligation risk because a material increase in the pension scheme's deficit under adverse conditions will have a negative impact on their CET1 capital.

The PRA's proposed methodology for pension obligation risk is to begin with a bank's own assessment of the appropriate level of Pillar 2A pension obligation risk capital, taking account of any accounting deficit already deducted from CET1 capital, and then to review this using two prescribed stress tests (with the nature and severity of these stress scenarios subject to annual updating).

For 2016 the stress scenarios are not particularly severe, which may explain why the PRA's cost benefit analysis

states that some smaller banks will benefit from a reduction in their Pillar 2A pension obligation risk charge.

5. Other types of risk

The methodologies for market risk, counterparty credit risk and interest rate risk in the banking book remain unchanged, but as with the proposed revised methodologies these are published in detail for the first time.

Pillar 2B capital

There are two elements to Pillar 2B capital: the 'PRA buffer', which replaces the existing capital planning buffer, and additional capital to cover risk posed by weaknesses in a bank's risk management and governance.

1. PRA buffer

The PRA buffer is determined by the results of concurrent stress testing, based on the approach set out by the PRA in October 2013, and bank's own stress tests. In addition, the PRA may take into account a bank's leverage ratio, the extent to which it has already used up its capital conservation buffer, and the extent to which bank-specific risks are not captured fully in the stress test.

The stress test will show the amount by which a bank's capital ratio declines under stressed conditions.

The PRA will then consider how much CET1 capital a bank needs to hold to reduce the risk that, as a result of the stress, a bank's CET1 capital would fall below the sum of (a) the bank's Pillar 1 minimum CET1 requirements, excluding the capital conservation buffer and any G-SIB or D-SIB buffer, and (b) the CET1 component of a bank's Pillar 2A capital requirement.

A PRA buffer will only be set if the capital conservation buffer and any G-SIB or D-SIB buffer are insufficient to reduce the risk of a bank falling beneath its minimum CET1 capital requirements as a result of a stress scenario.

Any PRA buffer will be expressed as a percentage of a bank's total RWAs. This is a significant change, which will link this buffer to the size of a bank as measured by its RWAs and will introduce a degree of pro-cyclicality to the buffer as a result.

2. Risk management and governance

Where the PRA assesses a bank's risk management and governance to be significantly weak, it may apply an additional CET1 Pillar 2B capital requirement of between 10 and 40 percent of the bank's CET1 Pillar 1 capital requirement and the CET1 element of its Pillar 2A capital requirement. So this would be more severe for a bank subject to higher Pillar 2A capital requirements.

However, the PRA recognises that the first-best solution here would be for the bank to improve its risk management and governance. So a bank will also be expected to produce a plan to address the failings that give rise to the additional capital requirement. Once these failings are remediated, the scalar would be removed.

Data and reporting

Although the PRA will make as much use as possible of existing reporting by banks, the consultation paper includes a set of proposed reporting templates for each of the Pillar 2A methodologies, covering either the data required by the PRA to implement these methodologies, or the result of the methodology as calculated by the reporting bank.

Disclosure

Pillar 2A capital requirements affect the capital ratio at which automatic capital distribution restrictions are triggered under CRR. This has already led to increased market interest in these requirements, and some banks have already disclosed their overall Pillar 2A capital requirement.

From January 2016, the PRA will let banks decide on whether to disclose their aggregate Pillar 2A capital requirement. Banks will be expected to notify the PRA in advance of any such disclosure, and the components of Pillar 2A and the PRA buffer will remain confidential unless disclosure is required by law.

Cost benefit analysis

The PRA's cost benefit analysis focuses primarily on the Pillar 2A capital requirement (since the PRA expects PRA buffer requirements to be similar to the existing capital planning buffer requirements).

Banks with low credit concentration risk may see a reduction in capital, whereas firms with high credit concentration risk are likely to see an increase in capital.

Banks on the SA specialising in high risk activities may see an increase in Pillar 2A credit risk capital requirements, because the IRB benchmarks for these exposures will be higher than the SA risk weights.

Overall, the PRA estimates that smaller firms should see a reduction in total Pillar 2A capital requirements, with material decreases in pension risk and credit risk capital more than offsetting increases for credit concentration risk.

The PRA estimates the impact of the proposals on large banks and investment firms to be an increase in overall Pillar 2A capital requirements of 0.23 percent of RWAs – which is less than 10 percent of total Pillar 2A capital requirements for these banks.

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