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Benchmarks in the Pillar 2 capital framework

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Why did the PRA reform its Pillar 2 capital framework?

International regulation is changing.

- CRD IV introduces a new system of buffers, whose purposes overlap with the existing CPB.
- The European Banking Authority (EBA) has issued new guidelines on how national competent authorities (i.e. the PRA) should carry out the Supervisory Review and Evaluation Process (SREP) and we have committed to comply with them.

The PRA's approach to banking supervision has changed too.

- Disclosure of Pillar 2A prompted the need for greater transparency and consistency.
- Our current approach was developed a long time ago and no longer fits well the new PRA approach to supervision.
- Current practices are opaque to firms.



Proposed changes to Pillar 2A methodologies

The CP proposes changes to our existing methodologies for assessing:

- credit concentration risk;
- credit risk;
- operational risk; and
- pension obligation risk.

We have delayed changes to the methodologies for IRRBB, market risk and counterparty credit risk intentionally, pending finalisation of the various Basel working groups (TFIR, fundamental review of the trading book).

The calibration of the new methodologies will be monitored and updated as necessary. Should we decide to do this, we will need to re-consult and consider whether transitional arrangements are required.



Developing the benchmarks

- Developing the benchmarks took approximately 18 months and was very resource intensive.
- We had input from risk specialists, supervisors, policy and legal.
- There were substantial issues to be solved in developing them.
- Carrying out an impact assessment took an extra year.
- The benchmarks we have consulted on are provisional and subject to refinement (with further consultation if they are changed).
- Our experience of applying the methodologies in practice from January 2016 may lead us to update them.



Pillar 2A methodologies - application

The proposed methodologies have been designed to support supervisors in determining Pillar 2A capital. None of the methodologies produce a single answer and they are not intended to; some are more mechanical but an element of judgement is required for each.

There are three steps to each:

1. **Capital estimates** - Capital estimates (usually a range) are calculated using data provided by firms. These are the starting point for assessing capital add-ons.
2. **Expert judgement** - Supervisors apply judgement to set capital add-ons taking into account the capital estimates and their knowledge of the firm.
3. **Peer review** - Proposed capital add-ons are compared across a firm's peer group to ensure judgement has been applied consistently.



Credit risk

- The methodology is used to assess whether firms on the standardised approach (SA) to credit risk need to hold additional capital under Pillar 2A.
- For some asset classes, SA underestimates capital and for some others it overestimates it.
- Firms' SA average risk weights are compared to an average IRB risk weight for all major asset classes to determine if additional capital across all major asset classes is required.
- When the new methodology was tested we found that no firms in the sample would be required to hold additional capital.
- We concluded that we would only perform this analysis if the firm was materially exposed to asset classes likely to be underestimated.



Credit concentration risk

- The Pillar 1 IRB approach for credit risk assumes perfect portfolio diversification. But many of the firms we supervise have concentrations to single names, sectors or international geographic regions, which is not adequately captured under Pillar 1.
- Firms will be required to calculate a Herfindahl-Hirschman Index for each source of concentration (single name, sectoral and geographic) and submit the data underpinning the calculation.
- For each source of concentration risk the firm's HHI-measure maps to a concentration risk bucket with an associated suggested capital add-on range.

Concentration Risk Bucket	1	2	3	4	5
Single name concentration risk (granularity):					
HHI _{RWA}	0% - 0.29%	0.29% - 0.59%	0.59% - 1.15%	1.15% - 1.65%	> 1.65%
Capital Add-on (% portfolio RWA)	0% - 0.5%	0.5% - 1%	1% - 2%	2% - 3%	3% - 4%
Sector concentration risk:					
HHI _{RWA}	11.1% - 20.3%	20.3% - 25.8%	25.8% - 41.7%	41.7% - 67.4%	> 67.4%
Capital Add-on (% portfolio RWA)	0% - 0.25%	0.25% - 0.5%	0.5% - 1%	1% - 1.5%	1.5% - 2.8%*
Geographic (international) concentration risk:					
HHI _{RWA}	11.1% - 24.9%	24.9% - 34.5%	34.5% - 47.8%	47.8% - 77.9%	> 77.9%
Capital Add-on (% portfolio RWA)	0% - 0.2%	0.2% - 0.5%	0.5% - 0.8%	0.8% - 1.25%	1.25% - 1.4%

*2.8% for CRE but 2% for financial.



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Credit concentration risk HHI buckets

- By default, the midpoint capital add-on should be applied but supervisors will retain discretion on whether the add-on should be at the lower or higher end of the range depending on their knowledge of the firm's business. This may include:
 - if RWAs are known to be underestimated, e.g. concentration of sovereigns;
 - when small firms place excess liquidity with a maturity of under 30 days with a limited range of counterparties.
- Peer review will ensure that supervisory discretion is exercised consistently.



Credit concentration - worked example

	Single name	Sector	Geographic
RWA £mn (portfolio in scope)	118,665	155,880	248,906
HHI	0.43%	17.5%	27.1%
Concentration risk bucket	2	1	2
Add-on range	0.5%-1.0%	0%-0.25%	0.2%-0.5%
Midpoint add-on £mn	593	195	622

The total concentration risk add-on is the sum of the individual add-ons for the three measures of concentration. In this example, assuming the midpoint for each measure is taken, the total add-on would be:

£593 mn (single name) + £195 mn (sector) + £622 mn (geographic) = **£1.4 bn**



Operational risk

- Pillar 1 standardised methodologies for operational risk are linked to firms' income and are therefore not risk sensitive.
- The proposed new methodology has been designed to apply to category 1 firms but supervisors will have the discretion to extend this approach to smaller firms.
- Conduct risks are considered separately from other operational risks because conduct risk is even more difficult to measure and model reliably, and so far history shows that conduct risk losses are independent from other operational risk losses.
- Due to the difficulty in modelling conduct risk, supervisory judgment will continue to be the main driver for setting capital.



Operational risk (continued)

- For non-conduct risks, three loss estimates are calculated to form a range:
 - **C1**, based on firms' forecast losses;
 - **C2**, based on firms' historic losses; and
 - **C3**, base on firms' operational risk loss scenarios.
- The conduct and non-conduct risk estimates are then summed.
- Peer reviews will be particularly important in ensuring consistent outcomes given the level of judgment required and wide ranges for suggested capital add-ons.
- For small UK banks and building societies we have assumed existing practices will continue, albeit with greater degree of peer comparability.



Pension obligation risk

- CRD IV requires the accounting valuation deficit of defined benefits pension schemes is deducted from CET1 capital. A unexpected and large increase in the accounting deficit will deplete a firm's CET1 capital.
- To align Pillar 2A with Pillar 1, we are proposing to stop using the funding deficit to as the basis for estimating the scheme's deficit and use the accounting deficit instead.
- We are also proposing to take a less generous stance on management actions and offsets. As a result we will no longer accept deduction from the stressed accounting deficit for future profits and deferred tax assets.
- The PRA will publish two stress scenarios and firms will calculate their stressed accounting deficit under both sets of assumptions.

	Scenario 1	Scenario 2
Fall in equity values	15%	30%
Fall in property values	10%	20%
Percentage reduction in long-term interest rates	10%	15%
Absolute increase in assumed inflation	0.5%	0.75%
Percentage change in credit spreads	-25%	+25%
Increase in liabilities due to a longevity stress	3%	6%



Pension obligation risk (continued)

- The results of the stressed scenarios will help to assess the firm's own calculation. If the firm's ICAAP is not reliable, the higher of the two stressed accounting deficit will form the basis of the Pillar 2A capital.
- In some exceptional circumstances the methodology may not reflect the complexity of the pension fund. Firms are asked to explain in their ICAAP why the PRA methodology is not suitable. Supervisors can then decide to call on the Pension Risk team to carry out a more bespoke assessment.
- Capital for pension obligation risk is expected to decrease across all peer groups as the stressed accounting deficit is generally lower than the stressed funding deficit.
- But firms currently benefiting from significant offsets could see an overall increase when those are removed.



Questions?



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