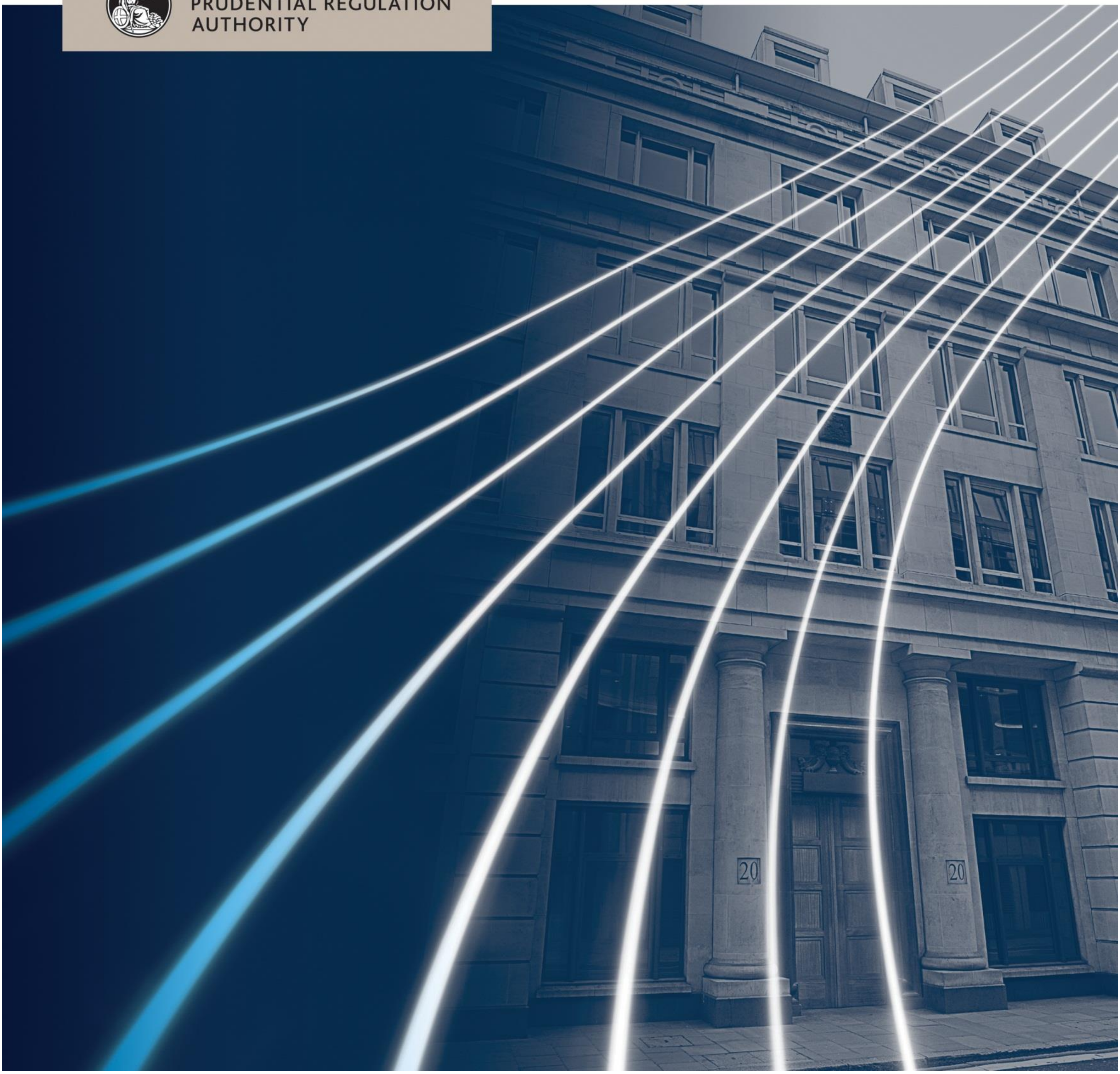
Policy Statement | PS15/20

# Pillar 2A: Reconciling capital requirements and macroprudential buffers

July 2020

BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY



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# Contents

# 1 Overview

1.1 This Prudential Regulation Authority (PRA) Policy Statement (PS) provides feedback to responses to Consultation Paper (CP) 2/20 'Pillar 2A: Reconciling capital requirements and macroprudential buffers'.[1] It also contains the PRA's final policy in Supervisory Statement (SS) 31/15 'The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)' (Appendix).

1.2 This PS is relevant to PRA-authorised UK banks, building societies and PRA-regulated investment firms ('firms').

## Background

1.3 In December 2019, the Financial Policy Committee (FPC) increased the UK countercyclical capital buffer (CCyB) rate that it expects to set in a standard risk environment from in the region of 1% to in the region of 2%.[2] This was a structural change in the FPC's UK CCyB rate in a standard risk environment.

1.4 At the time, the PRA announced that it would consult on proposals to reduce minimum capital requirements in a way that leaves overall loss-absorbing capacity in the banking system broadly unchanged.

1.5 Raising the structural level of the UK CCyB rate in a standard risk environment by 1% will improve the responsiveness of the capital standards to the economic environment. By shifting the balance of capital requirements from minimum requirements that should be maintained at all times towards buffers that can be drawn down as needed, these changes will mean that banks are more able to absorb losses while maintaining lending to the real economy through the cycle. A higher setting of the UK CCyB rate also allows the FPC to pursue a gradual approach to raising the buffer rate while also ensuring the banking system has sufficiently large useable buffers in place at the peak of the cycle.

1.6 The policy presented in this PS follows a review of the structural level and balance of capital requirements for the UK banking system undertaken by the FPC, PRC and the Bank of England (the Bank),[2] including the increase in the UK CCyB rate that the FPC expects to set in a standard risk environment and the Bank's clarification that, in resolution, it expects all debt that is bailed in to be written down or converted to common equity tier 1 (CET1).

## The proposed policy

1.7 The PRA proposed to reflect the additional resilience associated with higher macroprudential buffers in a standard risk environment with a reduction in Pillar 2A (P2A) capital requirements. The CCyB can absorb losses from the same risks currently capitalised in P2A. The proposed P2A reduction aims to keep total regulatory loss-absorbing capacity (LAC), defined as minimum requirement for own funds and eligible liabilities (MREL) plus buffers, broadly constant when the UK CCyB rate is 2%.

1.8 For firms whose MREL exceeds total capital requirements (TCR), ie Pillar 1 + P2A, the PRA proposed to reduce variable P2A capital requirements by 50% of the firm specific increase in the UK CCyB pass-through rate in a standard risk environment.[3]

1 February 2020 https://www.bankofengland.co.uk/prudential-regulation/publication/2020/pillar-2a-reconciling-capital-requirements-and-macroprudential-buffers
2 'Financial stability report', December 2019: https://www.bankofengland.co.uk/financial-stability-report/2019/december-2019.
3 The weight applied to the countercyclical buffer rate in the UK, calculated as the ratio of total own fund requirements relating to credit exposures in the UK to total own funds requirements relating to all credit exposures.

1.9 The PRA proposed to make an additional reduction of 50% of the firm-specific UK CCyB pass-through rate for firms whose MREL is equal to TCR, and which are considered to have a low risk profile by the PRA, to facilitate effective competition without prejudice to its general objective. While the PRA will apply supervisory judgement to the facts of each individual case, the additional reductions would keep a firm's variable P2A capital requirement above 1%.

1.10 The proposed reduction related only to the 1 percentage point structural increase in the standard risk environment CCyB rate announced by the FPC on Monday 16 December 2019. Any changes in the UK CCyB rate occasioned by the FPC's view of the prevailing risk environment would not be reflected in P2A.

## Reflecting the uncertainty of Covid-19

1.11 To support further the ability of banks to supply the credit needed to bridge a potentially challenging period, the FPC has reduced the UK CCyB rate to 0% of banks' exposures to UK borrowers with immediate effect.[4] The rate had been 1% and had been due to reach 2% by December 2020.

1.12 Active use of the CCyB in this way can dampen economic shocks and help to reduce the size of economic downturns, allowing banks to maintain lending to households and businesses through the cycle. However, the structural UK CCyB rate set in a standard risk environment has not changed. Therefore, the PRA considers that this policy to reduce P2A to reflect additional resilience associated with higher macroprudential buffers in a standard risk environment maintains the resilience of banks and the banking system.

1.13 In light of the Covid-19 pandemic, and high uncertainty surrounding the extent of the stress, the PRA will temporarily increase the PRA buffer for all firms that receive a P2A reduction. The PRA buffer will increase by 56% of the firm's total P2A reduction – ie the minimum amount of CET1 the PRA requires for firms to meet P2A requirements – until the UK CCyB rate begins to increase towards 2%. Using the PRA buffer does not trigger any automatic distribution restrictions. As such the point at which the automatic distribution restrictions apply that are required by European legislation (the Capital Requirements Directive IV (CRDIV)) will decrease for firms receiving a P2A reduction.

1.14 The Bank, the FPC and PRA have reiterated that all elements of the substantial capital and liquidity buffers that have been built up by banks exist to be used as necessary to support the economy, during this period of Covid-19-related stress. The PRA considers that firms can draw down on their capital buffers for this purpose.[5]

1.15 Firms can draw down on all available capital buffers starting with any additional capital buffer held above their regulatory buffers. While a firm should notify the PRA if its capital level is, or is forecast to be, below the level of capital the PRA requires it to maintain, this should just be viewed as part of its usual supervisory communication. This communication would include a discussion about the firm's plan to restore its buffers.

1.16 There is no pre-specified time period during which firms must rebuild their capital buffers. Once this current period of stress is over, where firms have drawn down their capital buffers, the PRA will give firms a sufficient period of time for these to be restored.

4 March 2020: https://www.bankofengland.co.uk/news/2020/march/boe-measures-to-respond-to-the-economic-shock-from-covid-19.

5 April 2020: https://www.bankofengland.co.uk/prudential-regulation/publication/2020/buffer-usability-qanda.

1.17 In doing so, the PRA will consider the individual circumstances of each firm; taking into account its capital restoration plan. These will include the firm's capital position and the need for firms to be able to support their customers and clients as they bridge the economic disruption related to Covid-19. Where capital buffers need to be restored this will be a gradual process and the PRA will not, in general, expect firms to restore their capital buffers in full until a significant time after the end of the current stress.

1.18 The FPC expects to maintain the 0% rate for at least 12 months, any subsequent increase would not be expected to take effect until March 2022 at the earliest. In addition, the pace of return to a standard risk environment UK CCyB rate of in the region of 2% will take into account how far firms' capital has been depleted through this period and thus the task to rebuild capital.

### Pillar 2 review

1.19 The PRA intends to review its P2A methodologies in more detail by 2024 in light of changes in buffers and improvements in the way risk-weighted assets are measured following the finalisation of Basel 3.

### Summary of responses

1.20 The PRA received 10 responses to the CP. Respondents commented on:

- the interaction between the proposals and the CCyB in the standard and current risk environment, with some respondents suggesting that the proposals be delayed;
- the interaction between the proposals and MREL, suggesting that the PRA make adjustments to the MREL or leverage frameworks;
- the additional reduction for small firms, with some respondents suggesting that the PRA remove the 1% floor;
- the impact on small firms, opposing the proposal as they result in higher LAC for small, low-risk firms; and
- suggestions that were outside the scope of this CP.

1.21 Following consideration of the respondents' comments, the PRA has decided to implement the reduction to variable P2A capital requirements as proposed.

### Impact of temporary measures

1.22 Due to the Covid-19 pandemic, the PRA has decided to temporarily increase the PRA buffer for firms that will receive a P2A reduction. Following this decision, the PRA has updated its cost benefit analysis to assess the interaction between this temporary measure and the P2A reduction.

1.23 For firms that will receive a reduction in P2A, the CET1 component will be temporarily retained in the PRA buffer. As a result, the impact on LAC will not be fully realised, and the CET1 requirements will be unchanged, while the temporary increase is in place.

1.24 The temporary increase in the PRA buffer will benefit the wider economy by increasing resilience, compared to implementing the proposed P2A reduction alone. Given that the magnitude of the economic shock from Covid-19 is highly uncertain, firms retaining capital promotes both the safety and soundness of firms and the resilience of the financial system. Reducing minimum capital requirements and increasing usable buffers will support banks' lending capacity throughout the stress.

1.25 Upon seeing the consultation, firms may have already put the reduction in P2A into their capital plans. The increase in the PRA buffer was not in the consultation paper and therefore these firms may see an additional cost in capital planning.

1.26 The two adjustments will be made at the same time. Therefore, there is no additional resource cost to implementing the adjustments for the PRA or for firms.

1.27 Firms that will not benefit from a reduction in their P2A will not have an increase in the PRA buffer. This decision has no impact on their capital requirements.

1.28 Once the temporary increase in the PRA buffer has been removed, the size of firms' reductions will remain the same over time in terms of percentage of risk weighted assets (RWAs).

## Implementation

1.29 The changes in this PS take effect from the publication date on Monday 6 July 2020. The PRA will assess the appropriateness of any reduction to ensure that the remaining P2A provides sound management and coverage of the risks to which each firm is exposed. The PRA will apply the P2A reduction, where applicable, on or before Wednesday 16 December 2020 and for efficiency align the assessment to related processes.

1.30 The policy set out in this PS has been designed in the context of the UK's withdrawal from the European Union and entry into the transition period, during which time the UK remains subject to European law. The PRA will keep the policy under review to assess whether any changes would be required due to changes in the UK regulatory framework at the end of the transition period, including those arising once any new arrangements with the European Union take effect.

1.31 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'[6] for further details.

1.32 The final SS 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'.[7]

1.33 As these changes relate to EU Guidelines, it should be read in conjunction with the joint Bank and PRA Statement of Policy (SoP) 'Interpretation of EU Guidelines and Recommendations: Bank of England and PRA approach after the UK's withdrawal from the EU'.[8]

6 April 2019: https://www.bankofengland.co.uk/paper/2019/the-boes-amendments-to-financial-services-legislation-under-the-eu-withdrawal-act-2018.
7 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.
8 February 2019: https://www.bankofengland.co.uk/paper/2019/interpretation-of-eu-guidelines-and-recommendations-boe-and-pra-approach-sop.

## 2 Feedback to responses

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

2.2 The sections below have been structured broadly along the same lines as the chapters of the CPs, with some areas rearranged to better respond to related issues. The responses have been grouped as follows:

- interactions with the CCyB;
- interactions with MREL and leverage frameworks;
- additional reduction for small firms;
- implementation; and
- comments outside of the scope the CP.

### Interaction with the CCyB

2.3 The PRA proposed to reduce P2A capital requirements with the aim of keeping LAC broadly constant following the FPC's decision to increase the CCyB rate it expects to set in a standard risk environment.

#### Definition of the standard risk environment

2.4 One respondent sought to confirm that the PRA's definition of a standard risk environment is aligned with the FPC.

2.5 There is no separate PRA assessment of the standard or prevailing macroeconomic risk environment, and the PRA does not set the CCyB. The FPC's approach to setting the CCyB is detailed in the Policy Statement 'The Financial Policy Committee's approach to setting the countercyclical capital buffer', April 2016.[9]

#### Interactions with the current risk environment

2.6 Several respondents suggested that the proposals should not be implemented while the UK CCyB is set at 0%. They expressed concern that the proposals reduce overall capital requirements.

2.7 The proposals in the CP related to the level of the CCyB in a standard risk environment, rather than to a change in the FPC's view of the prevailing risk environment. Any subsequent changes in the UK CCyB rate, up or down, based on FPC's view of the prevailing risk environment would not be reflected in changes in P2A. As such, the level of the prevailing CCyB does not affect the proposals in the CP.

2.8 The PRA's decision to temporarily increase firms' PRA buffers by the amount of CET1 reduction in their P2A requirements will ensure that firms are adequately capitalised to maintain lending and absorb losses during this stress. This decision reflects the high uncertainty surrounding the extent of the stress since the CP was published.

9 https://www.bankofengland.co.uk/statement/2016/the-financial-policy-committees-approach-to-setting-the-countercyclical-capital-buffer.

2.9 A respondent was concerned that the proposals reduce capital requirements at the top of the cycle, if the maximum CCyB is still set at 2.5%

2.10 There is no upper bound to the CCyB rate that can be set by FPC.[10] The Capital Requirements Regulations (CRR) give the FPC the power to raise the CCyB above 2.5% to address cyclical systemic risk.[11]

### Request for dynamic adjustment

2.11 A respondent requested that P2A be adjusted, including in between SREPs, as the CCyB impact changes because of changing CCyB pass-through rates.

2.12 The PRA will reflect material changes in a firm's pass-through rate. However, these will not, in general, be reflected until a firm's next SREP assessment. The PRA has decided not to make any changes to the final policy.

## Interactions with MREL and leverage frameworks

2.13 The proposals in the CP aimed to keep overall LAC in the banking system unchanged, however the PRA recognised that the proposed reduction in P2A cannot keep LAC unchanged for all firms. This includes firms for which LAC is determined by the leverage ratio, and for firms whose MREL exceeds capital requirements but is not equal to two times TCR.

### Interactions with MREL framework

2.14 Two respondents requested that the PRA make adjustments to the MREL framework, noting that firms during the MREL transition and those subject to internal MRELs above capital requirements would not have their LAC unchanged in a standard risk environment.

2.15 In the CP, the PRA recognised that LAC would increase for firms with transitional MREL requirements in a standard risk environment. However, no firm's LAC is expected to be higher in the transitional period than at the end-state.

2.16 The PRA acknowledged that firms subject to internal MREL above capital requirements would see a more limited benefit from the reduction in P2A. The PRA did not propose to make a further reduction in P2A, as it considered that 'material subsidiaries' would only have a small additional increase in cost relative to firms subject to external MREL in excess of capital requirements. The slightly larger benefit the latter firms would receive is in eligible liabilities, a relatively less expensive form of capital.

2.17 The PRA has decided not to make any changes to the final policy. The proposed amendments to P2A do not affect the framework according to which MREL are set by the Bank as the UK resolution authority.

### Interactions with leverage framework

2.18 A respondent requested that P2A be adjusted, including in between SREPs, as the CCyB impact changes because of changing CCyB pass-through rates.

2.19 In the CP, the PRA recognised that individual firms' LAC may increase where banks are bound by leverage. The PRA considers the leverage ratio an essential part of the capital framework, without

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10 April 2016: https://www.bankofengland.co.uk/statement/2016/the-financial-policy-committees-approach-to-setting-the-countercyclical-capital-buffer.

11 The Capital Requirements (Capital Buffers and Macroprudential) Regulations (2014), Chapter 2, 10(6).

which banks with low average risk-weights would be able to fund assets with substantial amounts of debt and very little equity.

2.20 The PRA has decided not to make any changes to the final policy to affect the leverage framework.

### Additional reduction for small firms

2.21 In the CP, PRA proposed to make an additional reduction of 50% of the firm-specific UK CCyB pass-through rate for firms whose MREL is equal to TCR, and which it considers have a low risk profile. The PRA considered that this would facilitate effective competition without prejudice to its general objective. In assessing a firm's overall capital adequacy when considering this further reduction, the PRA would also take into account the remaining capital necessary to ensure the sound management and coverage of the risks. While the PRA will apply supervisory judgement to the facts of each individual case, the PRA proposed to apply additional reductions that would keep a firm's variable P2A capital requirements above 1%.

#### Impact on small, low-risk banks and building societies

2.22 Some respondents expressed concern that when the CCyB is 2%, LAC will increase for banks with no, or negligible, variable P2A requirements, and for those who would not benefit from the additional reduction due to having insufficient variable P2A requirements to maintain the 1% floor.

2.23 The PRA recognised that the proposals could not keep LAC unchanged for all firms and that smaller firms with small or zero variable P2A capital requirements, such as those who benefit from the PRA's refined approach to P2A, would not receive the full, or any, benefit of this policy. However, the PRA considered that the refined approach to P2A itself already facilitates effective competition in the banking sector.

2.24 The PRA has decided not to make any changes to the final policy.

#### Firms with minimum base capital requirements

2.25 One respondent commented that firms whose capital requirements are determined by the base capital requirements in Article 12 of CRDIV will not benefit from a reduction in variable P2A requirements.

2.26 All CRR firms must hold the capital resources equal to or in excess of the base capital resource requirements set out in Rule 12.1 in the Definition of Capital Part of the PRA Rulebook. The proposals would not reduce minimum capital requirements subject to these base capital requirements.

2.27 One respondent suggested that applying a reduction to the PRA buffer as opposed to variable P2A would be more equitable.

2.28 The proposals aimed to keep overall LAC in the banking system unchanged in a standard risk environment, however the PRA recognised in the CP that the proposed reduction in P2A would not keep LAC unchanged for individual firms. On balance, after considering a range of options, the PRA considers that the proposed policy is the fairest approach across firms having regard to both its general objective and its secondary competition objective, and has decided not to make any changes to the final policy.

## Higher quality of capital

2.29 One respondent expressed concern that the proposals increase the cost of capital as the CCyB must be made up of a higher quality of capital than minimum capital requirements. The CCyB must be met with CET1.

2.30 In the CP, the PRA recognised the cost of the higher quality of capital needed to meet the CCyB. The PRA considers the prudential benefit of the enhanced resilience to outweigh the small incremental cost to firms. The PRA has decided not to make any changes to the final policy.

## Clarification on the 1% floor for the additional reduction

2.31 Some respondents asked for clarification of the 1% floor for the additional reduction proposed for eligible firms with MREL equal to TCR.

2.32 The PRA proposed an **initial reduction** of 50% of firms' UK CCyB pass-through rate, subject to supervisory judgement. In principle, all firms are eligible for this reduction. Firms whose MREL is equal to TCR, and are considered to have a low risk profile by the PRA, are eligible for an **additional** reduction of 50% in the firm specific UK CCyB pass-through rate of the increase in CCyB, subject to firms' remaining variable P2A capital requirements staying above 1%. Where a firm's variable P2A requirements would be below 1% after the initial reduction, no additional reduction would be applied.

2.33 Table 1 shows examples of the reductions that would apply to eligible firms with MREL equal to TCR.

Previous table:

**Table 1: Example reductions for eligible firms with MREL is equal to TCR, and a 100% UK CCyB pass-through rate**

| Starting variable P2A | Total potential reduction | Initial 0.5% reduction applied? | Variable P2A after initial reduction | Additional reduction subject to 1% floor applied? | Additional reduction | Final TCR |
|---|---|---|---|---|---|---|
| 3.1% | 100bps | Yes | 2.6% | Full | 50bps | 2.1% |
| 1.9% | 100bps | Yes | 1.4% | Partial | 40bps | 1% |
| 1.1% | 100bps | Yes | 0.6% | No | 0bps | 0.6% |

## Implementation

2.34 Some respondents questioned the planned date for implementation of the proposed reduction in P2A. Some respondents expected the proposals to be implemented by December as proposed. Other respondents encouraged the PRA to delay implementation, given the FPC's decision to set the CCyB at 0%.

2.35 The PRA has decided to implement the policy this year as proposed. The level of the prevailing CCyB does not affect the proposals in the CP.

## Comments outside of the scope of the CP

2.36 The remaining comments were outside the scope of the proposals contained in the CP. One respondent made a suggestion for an alternative approach to capital requirements. Any further changes to the capital framework are 'outside' the scope of the proposals contained in the CP.

2.37 One respondent made suggestions for the MREL review. The MREL review, which is a responsibility of the Bank as resolution authority, is 'outside' the scope of the proposals contained in the CP.

## Appendix

**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.**