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Financial Services Risk and Regulation

FSRR briefing

Pillar 2 Version 2

The PRA is implementing wide ranging changes to how the Pillar 2 capital adequacy framework operates for UK banks and building societies. It includes more systematic, consistent and transparent methodologies for assessing risk under Pillar 2. It also brings in new associated reporting requirements.

The PRA published Policy Statement PS17/15: Assessing capital adequacy under Pillar 2 on 29 July 2015 (with a 3 August update) together with a corresponding Statement of Policy and two Supervisory Statements. The changes being implemented are prompted by the introduction of CRD IV and by the publication by the European Banking Authority (EBA) of guidelines for the Supervisory Review and Evaluation Process (SREP). However the PRA goes further in its implementation-moving to a more risk sensitive approach which increases transparency and consistent application. This policy change applies to UK incorporated banks, building societies and PRA designated investment firms.

No significant changes have been made from the consultation paper published in January. Significant elements of the revised Pillar framework are:

- more systematic, consistent and transparent approaches to the assessment of risks under Pillar 2 by the PRA
- additional reporting requirements for firms where data is not already provided by other means
- firms are to be permitted to disclose publicly the total level of their Individual Capital Guidance (ICG)
- clarification of how the new PRA buffer assessment (Pillar 2B) will operate – replacing the capital planning buffer (CPB)
- the PRA buffer is to be met by CET1 capital by all firms but with phased implementation out to 2019
- for firms considered to have significant weaknesses in their risk management and governance (RM&G), the Pillar 2 requirement will be part of the PRA buffer (Pillar 2B) rather than Pillar 2A (as currently).

What is Pillar 2?

The Pillar 2 framework is intended to ensure the firms have adequate capital to support the relevant risks in their businesses, and to ensure firms have appropriate processes to comply with CRD IV. So Pillar 2 addresses risks to firms that are not adequately covered by Pillar 1 (Pillar 2A) and risks to which the firm may become exposed over a forward-looking planning horizon (Pillar 2B – PRA buffer). It is also intended to encourage firms to develop and use better risk management techniques in monitoring and managing their risk. The Pillar 2 framework includes an Internal Capital Adequacy Assessment Process (ICAAP) carried out by firms to analysis and conclude on the additional capital required and the regulators review of that process, the SREP.

Pillar 2A – Methodologies

The Statement of Policy sets out the methodologies that the PRA uses to inform setting Pillar 2 capital for firms (SREP) – the output being firms' ICGs (Pillar 2A) and the PRA buffer (Pillar 2B). The Pillar 2A methodologies are not intended to replace firms' own assessments. The PRA makes it clear that a firm attempting to only replicate the PRA's own methodologies will not be considered to be carrying out its own assessment in accordance with the PRA requirements. However firms will need to submit data to enable the PRA to apply these methodologies and where appropriate consider referencing in their ICAAPs. ICGs will be expressed as an amount of capital equal to 'X% of risk weighted assets, plus fixed add-ons' (currently expressed as 'capital in excess of 100+Y% of Pillar 1 plus fixed add-ons').

The PRA addresses seven risks. Of these, concentration risk, credit risk, operational risk and pension obligation risk have revised methodologies. Market risk counterparty credit risk and interest rate risk in the banking book are unchanged but are published in detail for the first time.

- **Credit Risk** – Under the revised methodology, where the PRA considers the credit risk of firms to be undercapitalised by the standardised approach (SA) it will examine the firms' average risk weight for each key portfolio compared to the average of internal ratings-based (IRB) firms' risk weights (in the form of a benchmark). It will also consider a range around the benchmark to support supervisory judgement. It is taking an 'unders and overs' approach so that for any portfolios where the credit risk under SA exceeds the IRB benchmark, the excess can be offset against any undercapitalised portfolios. The PRA does not expect the methodology to be routinely applied. Firms will only be asked to submit data to apply the methodology where the PRA has reason to believe the firm is likely to be have an aggregate under capitalisation of portfolios.
- **Operational Risk** – A two tier approach will be taken. The revised methodology will be applied to all Category 1 firms not using the Advanced Measurement Approach. It may also be extended to other firms if the PRA considers it appropriate. The methodology applies to non-conduct risk where the PRA will use three loss estimates to inform its assessment: C1-forecast expected loss, C2-historical five year average loss basis and C3-scenario based estimate. The add-on for non-conduct risk draws on the capital range generated by the C1-3 estimates, confidence in the firm's scenario analysis process and internal loss data, quality of the firm's operational risk management and measurement framework, peer group comparisons and the firm's own assessment. For conduct risk the add-on is informed by the PRA's knowledge of the firm's conduct risk exposure, is data dependent and driven predominantly by supervisory judgement. For firms not in the scope of the revised methodology, the PRA assesses operational risk on the basis of data provided by the firm, taking into account the firm's own assessment and supervisory judgement.
- **Concentration Risk** – To facilitate this revised methodology, firms are required to calculate a credit concentration risk measure, the Herfindhal-Hirschman Index (HHI) for all relevant portfolios (single name, predefined industry sectors and geographical regions). The HHI maps to a range of capital add-ons for which the PRA will apply supervisory judgement.
- **Market Risk** – The PRA identifies that the majority of risk not covered by Pillar 1 relates to illiquid, one-way and concentrated positions (referred to collectively as illiquid risks). The PRA's focus is the quality of firms' own methodology for assessing illiquid and concentrated positions including the magnitude of market shocks applied to assess illiquidity risks. The PRA also assesses the firms' abilities to manage the risk. The add-on is calibrated to ensure losses are covered at a 1-in-1,000 year confidence level. The PRA may also require an add-on where deficiencies in a firm's market risk systems and controls are identified.
- **Counterparty Credit Risk (CCR)** – A two tier approach will be taken. For risk covered by a CCR advanced model permission, the PRA's focus is on areas of risk that are not covered by internal modelling (e.g. concentration risk and settlement risk). For risks not covered by a CCR advanced model permission the review is broader and covers qualitative requirements for CCR, credit concentration risk, IT adequacy and data quality, settlement risk, collateral management, wrong-way risk, stress testing of CCR, model validation and limitations of non-advanced methods.
- **Pension Obligation Risk (POR)** – Under this revised methodology, firms are required to run two accounting based stress scenarios, in addition to their own assessment as part of their ICAAP submission. The PRA will start its assessment using the higher incremental deficit arising from the two stress scenarios. The add-on may be reduced by eligible offsets and management actions, but these must not depend on future financial performance and/or actions of third parties. Management actions should be capable of taking effect quickly enough mitigate the related stress.
- **Interest Rate Risk in the Banking Book (IRRBB)** – A two tier approach will be taken. For larger and more complex firms, the PRA applies a 'comprehensive approach' that involves reviews of duration risk, basis risk and as necessary optionality risk. Smaller and simpler firms are subject to a 'standard approach' which is based on reviewing firms' interest rate risk policy limits. If appropriate the policy limits are used as the basis for determining this add-on, usually the limits based on the economic impact of a 200 basis point shift in interest rates.

Pillar 2 add-ons could either be expressed as absolute numbers, percentages or scalars. Pillar 2A must continue to be met using CET1 capital for at least 56% of the requirement. Tier 2 cannot be used for more than 25% of it. This requirement ensures consistency with the capital allocation to Pillar 1 requirements.

Pillar 2B – The PRA buffer

The PRA buffer (Pillar 2B), will replace the current Capital Planning Buffer (CPB) from 1 January 2016. The purpose of the PRA buffer is to cover losses that may arise under a severe stress scenario, so that firms can continue to meet their ICG during a stress period but avoiding duplication with the CRD IV buffers (capital conservation buffer (CCoB) and systemic buffers). So a PRA buffer requirement arises where the PRA buffer assessment exceeds the CRD IV buffers. It is not a minimum to be maintained at all times like Pillar 1 and Pillar 2A, but rather a buffer that can be drawn down in adverse circumstances. The PRA expects firms to notify it as early as possible where the firm identifies that it will need to use its PRA buffer. The firms should also prepare a capital restoration plan.

Where the PRA assesses a firm as having significant weaknesses in their RM&G, the PRA will apply an additional amount to the PRA buffer. The PRA already applies this principle but it is currently reflected in Pillar 2A for those firms affected. The additional amount will be applied as a scalar in the range of 10-40% of the CET1 capital required to meet Pillar 1 plus Pillar 2A. This amount is not available for offset against the CRD IV buffers.

To ensure consistency, the RM&G scalar decision for any firm will be subject to a peer review process. The PRA will identify the weaknesses to the firm and expect the firm to address those weaknesses within an appropriate timeframe. When the identified weaknesses have been remedied the PRA will remove the scalar.

CPB can currently be met with total capital. As CPB transitions to the PRA Buffer, the proportion that must be met with CET1 will increase as follows:

- 25% by January 2016
- 50% by January 2017
- 75% by January 2018
- 100% by January 2019.

Some larger firms are already expected to hold their CPB in the form of CET1 capital and the above transitional arrangements do not apply to them.

The use of the PRA buffer does not lead to the automatic distribution restrictions that apply to the CRD IV buffers.

Disclosure

Pillar 2A will affect the capital ratio at which capital distribution restrictions are triggered under CRD IV and so is attracting market interest. Some firms have started making disclosures with the permission of the PRA. As a matter of policy the PRA is now allowing firms to disclose their overall Pillar 2A requirement and acknowledges that disclosure may include the components of the requirement where firms conclude that is it is required under market disclosure and transparency obligations. If a firm is planning to make public disclosure, the PRA still expects to be notified in advance. The PRA is still of the view that Pillar 2B should remain confidential.

Reporting

The PRA is introducing a new set of Pillar 2 reporting returns which will require system adjustments to report data relating to the risks driving Pillar 2 capital requirements. The PRA will use the data to assess the ICAAPs of firms and to calculate capital benchmarks for Pillar 2 risks. The reporting requires:

- all firms to submit data items containing their own assessment of the firm's Pillar 2A capital requirement
- all firms to submit data for concentration risk
- firms with defined benefit pension schemes to submit pension obligation risk data[1]
- PRA Category 1 firms and those on the Advanced Measurement Approach to submit data for operational risk[1]
- firms with permission to use the internal ratings-based (IRB) approach for retail exposures to submit data for retail exposures
- firms with significant illiquidity risk in their trading book to submit data for market risk
- firms using the standardised approach to credit risk to submit credit risk data – on request only

[1] = if data is not already submitted by other means (e.g. Firm Data Submission Framework).

Inevitably, the reporting requirements are more significant for PRA Category 1 firms (significant firms) albeit offset by what those firms already provide by other means. Whilst significant firms submit annually alongside their ICAAP submissions, other firms are to report on a regular and proportionate basis as determined by the PRA. In addition, the PRA may ask firms (including non-significant firms), to submit additional Pillar 2 data beyond the minimum on a case by case basis. Reporting starts from 1 January 2016 and the PRA acknowledges that the reporting will be a challenge for some firms but expects that data quality will improve over time.

Timeline

The new Pillar 2 framework will come into force 1 January 2016. The PRA have stated that where SREP reviews are planned between August and December 2015, it will discuss with firms the application of the revised Pillar 2A methodologies. The new ICGs emanating from these upcoming SREPs will be applicable from 1 January 2016.

The PRA has stated that it will write to all firms before 1 January 2016 to convert their existing Capital Planning Buffer into a PRA buffer that offsets against the CRD IV combined buffer. Where firms have an existing Pillar 2A add-on for risk management and governance, the PRA will relocate this to their PRA buffer and update IGCs accordingly.

Impact for firms

Firms will need to reflect on these changes and consider how they affect their own assessment in the ICAAP. It is perhaps no surprise, that disclosure by the PRA of their methodologies shows that some risks (e.g. operational risk) remain highly judgemental. That in turn reflects the challenges the PRA faces in making its assessment.

Capital requirements – The methodologies are in part a codification of what the PRA does already, particularly for larger firms, so some firms may not see much change. For others, additional Pillar 2 capital requirements could arise depending on firms' individual circumstances. For example, a firm on SA for credit risk, with large credit cards businesses and/or commercial real estate portfolios compared to the remainder of its loan book, could find itself with a higher credit risk Pillar 2A requirement.

Capital and risk management processes – Some of the Pillar 2 methodologies will result in firms needing to change their underlying risk management processes that are articulated in their ICAAPs, but also support other activities such as capital planning and forecasting, stress testing and recovery planning. This will require the incorporation of more information in firms ICAAPs (e.g. the POR stress testing scenarios). Others may require the submission of additional data to the PRA.

Reporting requirements – the new reporting forms are detailed and granular and this may add to the demands on banks' systems and resources for those that need to submit additional data. Firms will need to:

- source the relevant data internally
- remedy any data gaps (including sufficient granularity)
- develop controlled and repeatable processes to complete and submit the new forms
- develop contingency plans for data that the PRA may request in the future.

Disclosure – The pressure on firms to disclose total ICG is likely to increase as CRD IV buffers are phased in from January 2016. Firms should prepare for the additional disclosure, including qualitative elements, to be in a position to explain the numbers to investors.

What do I need to do?

You need to start planning for the implementation of the revised Pillar 2 requirements. The timetable will be informed by the timing of your next ICAAP review and PRA SREP. Planning will involve assessing what Pillar 2A PRA methodologies apply to your firm, considering any necessary changes needed to your firm's risk management processes and, consequently, the changes in not only your ICAAP production process but other risk and regulatory exercises like recovery planning and stress testing. You should begin identifying the additional data and resources needed arising from the changes identified and for the new PRA reporting requirements. The planning should be considered in conjunction with other developments that affect capital requirements such as the leverage ratio and potential forthcoming changes to the pillar 1 regime for credit, market and operational risk.

PwC has significant experience of assisting banks with their ICAAPs and stress tests and we are available to go through these methodologies for your bank and help you to assess the impact on your business and support the implementation of the revised Pillar 2 framework.

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Financial Services Risk and Regulation

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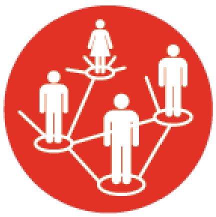

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