The voice of banking

Assessing capital adequacy under Pillar 2

A response by the British Bankers' Association to CP 1/15

April 2015

Introduction

The BBA is the leading trade association for the UK banking sector with more than 200 member banks headquartered in over 50 countries with operations in 180 jurisdictions worldwide. Eighty per cent of global systemically important banks are members of the BBA. As the representative of the world's largest international banking cluster the BBA is the voice of UK banking enabling us to represent our members domestically, in Europe and on the global stage. Our network also includes over 80 of the world's leading financial and professional services organisations. Our members manage more than £7 trillion in UK banking assets, employ nearly half a million individuals nationally, contribute over £60 billion to the UK economy each year and lend over £150 billion to UK businesses.

All of our members, large UK high street banks, wholesale and foreign banks supervised by the PRA in the UK as well as smaller and challenger banks will be affected by CP1/15 so the BBA is please to respond on behalf of its members to the Prudential Regulation Authority's consultation on assessing capital adequacy under Pillar 2[1].

We have focussed our observations on the elements of the Pillar 2 framework which are subject to change (covered in Appendices 2 and 3) but also have some more general comments, which we set out below.

General Comments

We support greater transparency

Our members welcome the PRA's initiative to bring more transparency, and thereby consistency, to the way in which its supervisors assess capital adequacy under Pillar 2. However, we believe that the PRA could provide more transparency and clarity on the methodologies implemented by the PRA, particularly for operational risk, pensions risk, concentration risk and the application of the risk management and governance buffer. Further details are given later in our response. Greater transparency and clarity on the methods used by PRA can lead to a more effective consultation process with market participants which adds value to the regulatory framework.

As an important component of the capital regime, it can have a significant impact on our members' capital levels Pillar 2 and is therefore also of interest to the wider investor community, who are

[1] http://www.bankofengland.co.uk/pra/Documents/publications/cp/2015/pillar2/cp115.pdf

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suppliers of capital to the banking industry, as they seek to understand likely future returns on capital and the likelihood of additional calls for funding.

An internationally harmonised approach

The PRA has been a pioneer in the application of rigorous, quantitative and qualitative Pillar 2 requirements which we support. Other regulatory authorities are now becoming more engaged with the Pillar 2 debate and there is the possibility that the Basel Committee will undertake work on this topic in the future. But there remains significant inconsistency across jurisdictions in the application of the Pillar 2 framework.

We note the European Banking Authority (EBA) has recently finalised its guidance on Pillar 2. These guidelines extend the focus of the SREP from capital adequacy to a much more comprehensive assessment of a bank's business and risk profile, including underlying business model characteristics and risks, financial resources, governance and controls, using a scoring based-approach which enables peer comparison. We assume that the PRA is comfortable that CP1/15 when implemented and added to the PRA's existing pillar 2 approach will make it fully compliant with the EBA's guidelines, as we believe it will be.

We believe the Pillar 2 framework should not be used by National Competent Authorities to circumvent or 'gold plate' legal requirements set out in the CRD IV legislative package or to apply supervisory discretions that international regulators have agreed to withdraw. This undermines the concept of an internationally harmonised regulatory capital framework and introduces perverse incentives for banks to engage in regulatory arbitrage.

We would encourage the PRA to continue to actively engage with international regulators on the development of a harmonised capital framework and how Pillar 2 can remain a valuable part of the regulatory and supervisory regime.

To the extent that any eventually agreed international principles or guidelines differ from the PRA's regime we would expect the PRA to consider the need for consequent changes to its Pillar 2 assessment methodology to ensure that our members are subject to an internationally harmonised approach.

Capital is not the only answer

The Basel 2 framework accepted that increased capital in the supervisory review process should not be viewed as the only option for addressing increased risks confronting banks. Other means for addressing risk, such as strengthening risk management, applying internal limits, strengthening the level of provisions and reserves and improving internal controls, must also be considered. Furthermore, regulatory capital should not be regarded as a substitute for addressing fundamentally inadequate control or risk management processes.

We wish to reiterate strongly that capital is not the only answer, and crucially, it is not always the best or most appropriate mitigant for risk. We have some anxiety that supervisors are less concerned that risks are dealt with appropriately by engaging with the firm to determine whether appropriate strategies and mitigants are in place than to ensure that a firm has surplus capital.

Avoiding duplication

The PRA has stated that its approach to Pillar 2A will result in a redistribution of capital requirements with higher total capital requirements for systemically important firms. We consider that the quantity of capital held should be commensurate to the level of risk, rather than the size or age of a bank, and capital add-ons should only be applied where there is no other more suitable method of addressing the risk. Additionally a number of structural reforms including TLAC and leverage and capital buffer already address risks associated with G-SIFIs.

Similarly it would be helpful if the PRA could explain how it will ensure that there is no double counting of any RM&G add-on with the operational risk assessment or other Pillar 2A specific risk assessments.

Utilisation of own approaches

The CP suggests a firm should continue to use its own methodology even if this differs from the methodology in the CP. Examples are pension risk and concentration risk. PRA will consider both when setting ICG. Does this mean that PRA will be prepared to set ICG based upon the firm's method, even if this gives a lower amount than the PRA's method? If that is not the case then it is likely that firms will be incentivised to abandon their own methods and will use only the PRA's method.

In this context it is important to highlight that one of the objectives of the Pillar 2 framework was to encourage banks to develop and use better risk management techniques in monitoring and managing their risks. The Pillar 2 framework is intended to foster an active dialogue between banks and supervisors such that individual firms hold an adequate level of capital for the risks to which they are exposed. The use of regulator defined models and approaches - which are by design simple and not risk sensitive – to determine bank-specific capital requirements does not provide the right incentives and can increase systemic risk by reducing diversity.

We believe the original intention of the Pillar 2 framework was to appropriately tailor regulation and supervision of banks to their size, complexity, and risks, to ensure that regulators avoid a one-size-fits-all approach. This is still a valid approach and consequently we urge the PRA to avoid the pitfalls of using a one-size-fits-all approach Banks internal approaches should be the primary input used to determine ICG. We recommend that PRA methodologies should primarily be used as a means to identify outliers.

Appendix 1 – *Reporting*

Timing and frequency

Could the PRA could clarify the frequency of submissions? Does the PRA expect that all the templates are to be submitted with every ICAAP submission or just those relevant to the particular risk types it is examining in a particular SREP review? We would expect the latter.

We would also welcome greater clarity about the format and timing in relation to submission of the additional operational risk and credit underestimation risk data. We assume that these requests will come through supervisory teams but it should be noted that banks will require sufficient notice to build such requests into their forward reporting plans which will require engagement across the business – could the PRA expand on notice periods and how this will fit into the ICAAP cycles? For example if an ICAAP is due for submission to the PRA on a 2 year cycle, we would not expect there be interim ad hoc requests for the template data, but request that the PRA confirm this.

The reporting requirements should not apply until the final rules have been fully implemented as firms will need time to adjust to specified requirements, which are still being clarified. Further, firms will need time to implement systems and processes and therefore a reasonable implementation timeframe must be given to firms from the date the rules are finalised.

It will also be important to ensure greater alignment with the FDSF in order to avoid different reporting requirements. Could the PRA consider waiving the requirements for FDSF firms to complete certain the data templates?

Credit risk templates

Clarity is required as to what "exceptional basis" would be. Would it be based on quantitative thresholds?

We assume this would apply to IRB firms for exposures under SA partial use?

FSA076: Pillar 2 credit risk SA wholesale

- CP1/15 Appendix 3, Chapter 2, Table A provides a ‘credit risk IRB benchmark’ - it is worth noting that the SA RW for the following is higher than the level banks are required to hold under Pillar 1.
- Commercial real estate: CRR 50% applied to <= LTV of 60% (article 126).
- Is all CRE lending is to be treated as wholesale, even if to SMEs?
- Are balances to be reported on an obligor basis?
- Exposures under CRR Article 112 b. regional governments or local authorities c. PSEs, d. MDBs or e. international organisations – are these excluded from the reports?
- Under CCR Article 128 ‘speculative immovable property’ is a high risk item but could also meet the definition of CRE development. We note that the definition provided for CRE development and CRE Investment – CRE as in COREP under Article 126.2(b) these exposures would not be considered commercial immovable property.

FSA077: Pillar 2 credit risk SA retail

Guidance on terms used: FSA077, FSA082 Mortgages with impaired credit history.

This category does not appear in either template – is this an error?

FSA079: Concentration risk

For single name concentration risk:

- How are portfolios to be split for the purposes of calculating the Herfindahl Hershmann Index (HHI) index per portfolio (e.g. corporate / sovereign / institutions / CRE / other as per FSA076 or some other split)?
- Is the HHI index calculated across the entire portfolio or just the largest 20 exposures in each portfolio?

Operational risk

The additional reporting requirements for operational risk will create significant additional work, making the January 2016 completion date (if that would be the envisaged date as suggested by the PRA) very difficult to achieve.

FSA 072 and FSA073

Templates FSA 072 and FSA 073 for Operational Risk potentially duplicate data already submitted quarterly by banks making FDSF submissions. Would the PRA consider granting FDSF banks a waiver from the requirements to submit these two templates?

FSA 073 requires the bank to notify the occurrence date of operational loss events. Is this date the date of the occurrence date, the discovery date, or the accounting date? More generally, the restrictions in the data template do not capture the complexity of the losses occurring in multiple locations and spanning across several dates.

FSA 074

The completion of FSA 074 will create additional operational loss projection modelling requirements for banks already subject to AMA and for such banks the supervisory value of the these forms to the PRA is not clear. Would the PRA consider waiving the requirement for AMA firms to complete these forms?

It would be helpful to have clearer definitions and additional guidance from the PRA concerning the required distinction in reporting among Non-Conduct, Conduct and Legal loss events. Could the PRA confirm whether banks can use CPBP as a proxy for conduct losses, since the splitting of events and in particular scenarios into conduct and non-conduct risks would be problematic as most risks could potentially result in conduct impacts?

FSA 075

The scenario workshop documentation requirement would be a resource intensive process. For instance the template requires disclosure of specific probabilities against each scenario whilst probabilities at this level may not always be available.

Pension Risk

FSA081

Populating this template could be onerous for some firms with multiple sections within the same scheme, and the additional granularity provided by completing all cells may not provide materially useful additional information. Will there be some firm discretion permitted in the completion of this template in terms of the breakdown of information by section?

IRB credit risk

FSA 082

- Is all residential-backed lending is to be treated as retail –even if the borrower is an SME?

Appendix 2 – *draft Supervisory Statement*

Expectations of firms undertaking an ICAAP

We note and agree with the PRA's expectation that the ICAAP should be prepared at least annually and more frequently if business model or strategic developments suggest that a re-assessment of financial resources is required. Equally, strategic developments may result in a significant reduction in risk, for instance following a disposal, and so a firm should be able to apply to reduce its Pillar 2A buffer in this event.

Stress testing

We broadly support the PRA's proposals in relation to stress testing and note that our larger members and the supervisor are already devoting considerable attention and resource to regulatory-driven stress testing which is becoming a business-as-usual activity. For many years banks have recognised stress testing as a very useful risk management practice for understanding points of weakness, identifying exposures concentrations and managing extreme tail risks in a portfolio.

But we recommend that the roll-out of the concurrent stress testing framework to firms that are not currently in scope should be subject to significant advance notice so that banks can prioritise and implement the infrastructure, reporting and resourcing required for the PRA defined stress tests. Up until now banks' stress testing frameworks have developed independently as most banks have used the practice for internal risk management.

Our expectation is that the PRA buffer assessment and concurrent stress testing framework should in time be merged, particularly if stress testing is applied more widely to include our smaller member banks, although we recognise that this is not feasible in the shorter term.

The SREP

How will 'in-flight' SREPs be addressed? We would be concerned were some firms to be subject to new methodologies ahead of finalisation of consultation. This could lead to different firms being subject to differing requirement and, during the transition period, create an uneven-playing field?

We believe that supervisors should not front-run changes to regulatory policy by implementing the proposed changes in the 2015 cycle of SREP reviews. Implementing policy changes prematurely - which are subject to ongoing consultation with the industry and other stakeholders - undermines the consultation process and could lead to inconsistent outcomes if there is a disjointed move to new rules. We expect that PRA will only implement, both in theory and in practice, the new Pillar 2 framework from 1 January 2016, as stated in the consultation paper.

It would be helpful to have a better understanding of the overall calibration of Pillar 2A and Pillar 2B. For Pillar 2A the CP refers to various confidence levels (1/1000, 1/200, 1/100) but what is PRA's overall view? We note that if the leverage requirement is binding then the effective calibration is even higher. What is PRA's view of the overall calibration and severity of Pillar 2A and Pillar 2B combined?

We are uncertain of the rationale for the process described in paragraph 4.17 for ensuring that a firm cannot use the same CET1 capital to meet both its ICG and CRDV buffer requirements and that it should apply for a FSMA section 55M prevention – can the PRA explain the legal rationale for this process and whether this results from the provisions of CRD IV? Must a firm apply for this requirement every year and what is the process for doing that?

Risk management and governance

Our members recognise that the PRA already makes an assessment of a bank's risk management and governance (RM&G) framework as parts of its supervisory review process and discusses with it areas of perceived weaknesses in order to agree a remediation plan where necessary.

When setting an add-on for weaknesses in risk management, the PRA should explain clearly what the weaknesses are considered to be and ensure that the same weaknesses are not also the subject to an existing add-on e.g. duplication of capital add-ons for credit risk and RMG scalar for credit risk management. It should be made clear how the risk management and governance scalar will be applied to new banking licence applications if at all.

It would be helpful if the PRA could explain how it will ensure that there is no double counting of any RM&G add-on with the operational risk assessment or other Pillar 2A assessment.

Banks will also wish to form their own assessment of their RM&G framework. So it would be helpful for our members to understand better the key factors that the PRA:

- employs in making determinations that a significantly weak RM&G environment exists;
- the processes it will employ to ensure its supervisors apply their judgement consistently across peer groups of firms; and
- the nature of any appeals process.

Is the scope of the governance limited to the governance of risk management systems, controls and processes or does the PRA envisage it to include governance of conduct issues, for instance new product approval processes?

As we note above it is not clear to us that a capital scalar is the right solution to a firm that in the PRA's view has significantly weak RM&G problems. It appears to us that such scaling up is purely a penalty for firms. In our view the PRA's argument that extra capital might 'buy it time' as weaknesses are resolved is not a strong one in an environment where the firm has been subjected to robust stress testing, has a credible recovery plan and will be holding Loss Absorbing Capacity over and above its capital requirements. So we see scaling up as more of a penalty and in light of the potentially significant additional capital requirements we seek assurance from the PRA that:

- Where concerns exist the firm's supervisor will have already raised them with the firm;
- it views an RM&G scalar as the exception not the rule which would be deployed only if the PRA believes that the firm is subject to severe risk; and

- once the RM&G failing has been addressed the scalar would be removed immediately, without waiting for the next SREP.

Disclosure

Our members note that there is an increasing trend to disclose Pillar 2A, following pre-notification to the PRA, in recognition of the fact that it is a component of a bank's capital ratio, depletion of which may affect the degree to which dividend distributions are curtailed by the operation of the capital conservation buffer.

We note the PRA's intention is that individual sub-components of the pillar 2A buffer will not be disclosed by firms. Our members are not sure of the extent to which non-disclosure of components would conflict for instance, with a senior manager's responsibility to be transparent to the market in order to comply with Stock Exchange rules. Our assumption is that the PRA would not prevent a firm disclosing Pillar2A components were it to be legally required to do so.

Pillar 2B is not currently disclosed and although we do not believe that there is appetite amongst our members to do so, some members believe that there is also pressure to disclose this given the focus on stress testing and CET1 capital buffers and therefore this is an area that may require re-assessment.

We support the PRA's intention to publish aggregate statistics on the level of Pillar 2A capital annually in the Bank of England's Financial Stability Report.

Appendix 3 – *The PRA's methodologies for setting Pillar 2 capital*

Pillar 2A

Credit Risk

We are generally concerned that the approach chosen by the PRA will be over-riding the risk weights that have been agreed as part of the design of the Pillar 1 framework. We note that this seems out of line with an approach whereby perceived shortcomings in the Pillar 1 framework should be addressed in Pillar 1 rather than through the use of capital add-ons in Pillar 2.

We are also concerned with the lack of transparency around the benchmarks used and how supervisory judgement will be applied to arrive at a calculated add-on.

In terms of scope of application, greater clarity would also be welcomed, for example as to how this approach would apply for IRB banks with exposures under partial use or on roll-out.

For a standardised bank with high credit quality will the risk profile be taken account of in applying appropriate risk weights, considering the bench marks appear extremely high? It is noted that there is scope for the exercise of supervisory judgement: - how would this be applied?

For purposes of the methodology, a calculation on an aggregate basis is undertaken. However firms with significant exposures to high LTV and credit cards may be subject to an add on – on an exceptions only basis. Will this mean reverting to calculations at portfolio by portfolio level if it is considered to have these significant exposures? It would be helpful if the PRA could better explain how such "aggregate basis" calculation would be undertaken.

For the avoidance of doubt, could the PRA clarify the proposed treatment for EU Sovereign exposures, as footnote (a) in Table A does not explicitly cover this?

Operational Risk

Overall, we are concerned that the proposed approach is complex, not transparent and out of line with best practice in the industry to model operational risk.

The approach outlined applies to all PRA Category 1 firms but may be extended to other firms depending on the level of sophistication of the firm's operational risk management. Whilst this gives the PRA flexibility it leaves much uncertainty about the approach that banks should be taking. Therefore we would seek more clarity on how a non-category 1 bank should be developing it operational risk processes in order to ensure more consistency. There is concern that a non-category 1 bank may be asked to comply at short notice with a certain methodology which has not been sufficiently developed. The idea of 'AMA standard' firms may be considered confusing – would this be assessed by the firm or the supervisor?

In determining the operational risk add-on the PRA is proposing to take into account the results of the C2 calculation the five largest losses for each year and subject them to a 1 in 1000 confidence level. So firms that have a small number of large scenarios will be subject to greater capital requirements than those with multiple small scenarios. A drawback of this approach may be to incentivise the use of multiple small scenarios rather than accurate risk assessment.

Conduct risk

There may be a number of different approaches to conduct risk modelling technique, including estimations based on historical data-based, subject matter expert opinion or parametrically-based techniques involving, fitting to internal/external conduct-risk loss data. Does the PRA have views on which approaches could be used for the estimation of the Expected Loss for conduct risk?

Can the PRA provide more clarity on the period to be taken into consideration when considering potential exposures derived from conduct-related scenarios?

We are concerned with the statement that CPBP losses are considered a proxy of conduct risk losses (paragraph 4.7 Appendix 3). Under the proposed rules, Pillar 2A capital for conduct risk will be informed by a firm's largest conduct losses over the past five years and the level of expected annual loss for conduct risk (paragraph 4.14). We infer from this that the PRA intends to use a firm's CPBP losses that may not necessarily be conduct related, to inform their supervisory judgment.

We recommend that the PRA should require firm's to distinguish between conduct and non-conduct CPBP losses in the reporting template. This could be achieved, for example, by using the Basel II Level 2 categories as a means of distinguishing such losses. As such, the PRA would be able to determine a firm's conduct risk capital, based in part, on the actual conduct risk losses reported and not CPBP losses.

Non-conduct risk

C1 Operational Loss estimate

Can any quantitative model/distribution/modelling approach be used for the generation of the C1 loss estimate?

Can the PRA provide any guidance or further clarity regarding the statement the "… assuming a given relationship between expected loss and unexpected loss"? It seems that the PRA is assuming the use of a Loss Distribution Function as in the AMA – could this be confirmed?

C2 Operational Loss estimate

Will the 'shape parameters' be available for the firms under PRA supervision?

C3 Operational Loss estimate

Can scenarios used at the firm-wide level be used, after proper scaling, for the UK PRA-regulated legal entities?

Would a scaling based on revenues be acceptable or should the risk profile be dominant?

How will the mentioned diversification benefit will be quantified?[2] Should it be calibrated by the financial institutions themselves or as for the AMA, should tail dependent architectures (for example t-copula with 3 degrees of freedom) be selected?

New challenger banks may have difficulty in sourcing data over 5 years, resulting in costs to access external data, such as the BBA's GOLD database. In the meantime will there be transitional arrangements to take account of the time taken to develop and embed the new approach? Would a full scenario based approach be accepted to build the loss distribution functions?

It would be helpful if the PRA were to provide greater clarity on 4.16 and specifically, how it envisages using supervisory judgement to determine the Operational Risk add-on. CP1/15 states the PRA considers the firm's assessment, quality of its framework and peer group comparisons. What is not clear is whether and/or the extent to which add-ons will be punitive if PRA expectations are not met.

Credit Concentration risk

Concentration risk is multi-faceted and complex and can be cut in a range of ways, for instance by sector, by geography or by obligor. We believe that a Pillar 2 assessment of capital adequacy is more appropriate than a purely formulaic Pillar 1 add-on, because concentration risk should be considered on a case-by-case basis and take account of how each firm risk measures, monitors and manages the specific concentration risk to which it is exposed.

For instance there is no benefit given for collateral. A Standardised bank with strong collateral may make its own assessment of concentration risk using an IRB-equivalent platform. Absent the ability

[2] The C3 estimate is obtained by summing the five largest annual impacts to which a predefined diversification benefit is applied. The same diversification benefit is applied to all types of firms.

of the bank to use its own assessment as the primary tool (as we would prefer) an alternative could be to use the low-point of the range for collateralised exposures.

We are concerned that the PRA's Pillar 2 CP appears to remove the flexibility and risk sensitivity which allows banks to assess concentration risk in favour of a simpler approach which does not account for differing portfolio composition and is not able to capture or sufficiently distinguish between the different concentration risks to which a firm is exposed. It is important to note that diversification in itself does not necessarily lead to risk reduction. Overtly focusing on diversification as a metric of credit risk may have negative risk management implications by providing the wrong incentives to firms.

The temptation to use a simple capital add-on calculation approach removes the link with portfolio risk management, the use of stress tests and other more accurate measurement techniques for credit concentration risks. While we recognise the supervisors' objective of applying consistent and comparable approaches to benchmark firms, we firmly believe that benchmarking should be used to identify outliers rather than to directly set capital levels.

Therefore, as we note above, we would strongly recommend that a firm's own internal assessment of concentration risk capital is the primary methodology used in the assessment of ICG. PRA's methodologies should only be used as a benchmarking tool and only if firms do not provide an adequate internal assessment of concentration.

Mapping economic capital to a simple look-up table

PRA propose to use a simple look up table to define capital requirements. This approach is based on the assumption of a linear relationship between the HHI - a common measure of concentration - and the underlying capital model which is used to calibrate the credit risk capital add-ons.

However, this linear relationship relies on certain simplifying assumptions about a bank's portfolio and is much weaker for real world portfolios. We believe PRA's approach does not capture the effects of credit quality, credit distribution or recovery. The effect of single name concentration on economic capital is sensitive to the credit quality and distribution of the portfolio. Gordy, the author of PRA's underlying model, states: *"It is difficult to accommodate this dependence in ad-hoc measures of granularity adjustments based on exposure HHI."* This means that the approach used by PRA may be appropriate to identify outliers but not to directly set capital requirements.

The same criticism can be applied to the approach used for sector and geography concentrations. In particular the methodology is less suitable for portfolios with a range of different PDs. As stated in a version of the PRA referenced paper "*We find that the model […] ceteris paribus overestimates EC [Economic Capital] in the presence of heterogeneity in individual PDs, in particular if creditworthiness increases with exposure size."*

While the methodology has the appearance of fairness because it is applied to all firms, it does not produce fair or comparable results because the methodology should be adjusted to reflect firm's individual portfolios.

One approach that would increase fairness and provide greater incentive for firms to reduce concentration risks would be to allow firms to use linear interpolation to determine the capital add-on instead of using the mid-point of the bucket.

<u>Sector Concentration</u>

PRA propose to calibrate sector and geography concentration risk add-ons using a multi-factor capital model which is compared to the IRB single risk factor model. We believe that the sector classification used by PRA does not have sufficient granularity to measure sector concentration risk and that real world experience shows that specialisation leads to lower capital write-downs and write-offs.

The sectors in the PRA methodology are defined in such a way that misses some concentration risks and spuriously captures other non-existent concentration risks

PRA propose to use "SIC" codes ("Standard Industrial Classification") to define sectors for the concentration risk add-on. We note that these codes are being phased out by the industry and replaced with NACE in the EU (Nomenclature of Economic Activities) and NAICS in the US (North American Industrial Classifications System). We believe PRA should introduce a more forward looking approach to defining sectors that does not require firms to maintain an outdated classification system that is being phased out.

SIC codes used by PRA have a hierarchy which groups industries by divisions, groups and sections. PRA have used the top level aggregation of "sections" in their methodology. However, it is important to highlight that each of these sections are not comparable. For instance *"Manufacturing"* includes 281 sub-sectors, many of which are not correlated with each other. Meanwhile another section used by PRA, *"Mining and Quarrying*", has only 17 sub-sectors which could reasonably be considered as significantly correlated. PRA's use of these classifications can lead to spurious results. This can be demonstrated using an illustrative example with two hypothetical portfolios:

Portfolio 1	PRA Pillar 2 Sector
Extraction of crude **petroleum**	<u>Mining & Quarrying</u>
Manufacture of refined **petroleum** products	<u>Manufacturing</u>
Wholesale of petroleum and **petroleum** products	<u>Wholesale & Retail Trade</u>
= Diversified Portfolio	

Portfolio 2	PRA Pillar 2 Sector
Processing and preserving of meat	Manufacturing
Reproduction of recorded media	Manufacturing
Manufacture of bricks, tiles and construction products, in baked clay	Manufacturing
= Concentrated Portfolio	

- Portfolio 1 contains exposures to a diverse mix of sectors used by PRA. While Portfolio 2 contains exposures which are all classified in the same sector. We would argue that Portfolio 1 is highly correlated, given its dependence on the oil price, and should be defined as a concentrated portfolio. However, PRA's methodology effectively applies spurious diversification benefit because these sub-sectors belong to different PRA sectors.
- Whereas portfolio 2, which contains a portfolio of exposures from unrelated sectors which would not be significantly correlated are defined as being in the same sector and therefore comprise a concentrated portfolio. In PRA's methodology portfolio 2 would be subject to higher concentration risk capital charges than Portfolio 1. The issue of misusing aggregated sector classifications is most acute for the Manufacturing and Wholesale and Retail Trade industries.

A bank's internal risk management and monitoring can capture this type of concentration using stress testing to identify exposure concentrations dependent on common risk factors such as the oil price.

Sovereigns are missing from the sector classification which produces misleading measures of concentration which is not comparable across firms

We understand that PRA has deliberately removed sovereigns from the sector concentration risk assessment because PRA believe that sovereigns are not correlated with each other and should therefore be treated as single name exposures. This approach has an unintended consequence on PRA's concentration risk assessment for the remainder of the portfolio. Arguably by having exposures to sovereigns, which PRA believe to be uncorrelated, a firm may diversify its portfolio away from concentrations to other sectors. However, by excluding this exposure sector in PRA's approach all other sectors appear to be more concentrated. This is best illustrated with a simple example:

Portfolio A			
Sector	**RWA (£bn)**	**%**	**HHI**
~~Sovereigns~~ (ignored)	~~25~~	-	-
Wholesale & Retail Trade	25	33%	11.1%
Services & Other	25	33%	11.1%
Transport, Storage & Utilities	25	33%	11.1%
	75*	**100%**	**33.3%**

Portfolio B			
Sector	**RWA (£bn)**	**%**	**HHI**
Mining & Quarrying	25	25%	6.3%
Manufacturing	25	25%	6.3%
Construction	25	25%	6.3%
Real Estate	25	25%	6.3%
	100	**100%**	**25%**

- In this example there are two portfolios: A & B. Each portfolio contains an equal proportion of exposures in RWA to each of four sectors.
- Portfolio A contains 25% exposures to Sovereigns. Under the PRA methodology these exposures must be ignored and only the remaining exposures are counted. This results in an HHI measure of 33.3%. This would fall into bucket 3 and be attributed a capital add-on of up to 1% of RWA. <u>A mid-point capital add-on of 0.75% would be applied</u>.
- Portfolio B contains no Sovereign exposures and therefore the calculation produces an HHI measure of 25%. This falls into bucket two and would be attributed a capital add-on of up to 0.5% of RWA. <u>A mid-point capital add-on of 0.375% would be applied</u>.
- Portfolio A is more diversified than Portfolio B because, as PRA has stated, Sovereigns are a diversified pool of single names and are not correlated with the other sectors.
- Under PRA's methodology, Portfolio A which is the more diversified portfolio has double the capital add-on of Portfolio B.

Consequently, we would recommend, at a minimum, that sovereigns are included as a sector in the HHI calculation, but that concentrated exposure to sovereigns will not be subject to an additional concentration risk charge. This approach would reflect PRA's belief that sovereigns are not correlated and more fairly reflect the diversification benefit that firms get from having exposures to sovereigns and other industry sectors.

Studies show evidence that specialisation leads to <u>lower</u> credit risk losses and that this effect dominates the increased risk from credit concentration risk

A review of academic studies shows that there is mixed evidence on the role of sector concentration risk on the credit risk of banks. There is evidence that specialisation benefits outweigh concentration risks in credit portfolios. Two Bundesbank studies[3] and an OCC[4] study have found that this effect dominates. I.e. a bank that has specialised resources to monitor and evaluate credit risk exposures to certain sectors can more effectively manage potential credit risk losses. This leads to lower overall portfolio losses.

The Bundesbank study uses HHI measures, like the PRA's methodology, to assess the impact of sector concentrations by analysing the credit write-downs and write-offs in the portfolios of real world banks. To quote from the Bundesbank study,

> "*The more concentrated the credit portfolio of a bank is (with respect to industries/sectors), the lower are the expected write-offs and write-downs in its credit portfolio. We control for the composition of a bank's credit portfolio."*
>
> *"The rate of write-offs and write-downs is calculated for each bank and for each industry/sector. We reveal that the average rate over all banks and the observation period is lower for each industry/sector which represents a focus of lending for a bank. This result holds for 25 out of 27 industries/sectors."*
>
> *"If the HHI in the credit portfolio increases by one standard deviation (0.136), then the portfolio loss rate goes down, on average, by 15 basis points."*

We believe that this evidence should make the PRA reconsider whether the approach in the consultation fairly reflects real world concentration risks.

Experience from the financial crisis shows that the default of pension funds is not correlated with other Financial Institutions

During the financial crisis there were a number of defaults in the financial institutions sector. In response there has been a fundamental overhaul of the regulatory and supervisory framework. However, pension funds did not exhibit significant correlation with other financial institutions. There were no pension fund defaults during the 2008-9 crisis. (See the appendix for a summary of the financial institution default experience during this period). We would argue that pension funds have a different risk profile to banks and insurance companies and should be considered separately in PRA's framework. We recommend that pension funds are removed from the Financial Institutions sector and included in a separate sector category.

Geographic Concentration Risk

For a UK focussed firm, geographic concentration risk is likely to be very significant in size due to such a firm having substantially all exposures allocated into the single United Kingdom category. For such firms, to ensure an appropriate magnitude of capital requirements for geographic concentration, the methodology should also consider other concentration risk-reducing factors such as diversification across UK regions, the distribution of exposure across sectors and credit quality.

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3 http://www.bundesbank.de/Redaktion/EN/Downloads/Publications/Discussion_Paper_1/2013/2014_01_13_dkp_53.pdf?__blob=publicationFile

4 http://www.occ.gov/publications/publications-by-type/occ-working-papers/2013-2009/wp2009-5.pdf

Similarly classing Europe as a single region creates a significant additional add-on and does not reflect the diversification within in.

Pension obligation risk

The PRA's methodology outlines that a set of stresses on an accounting basis are applied. However, the methodology does not specifically detail the expected basis on which a firm's own assessment of the appropriate level of Pillar 2A Pension Obligation Risk should be performed. A firm's own assessment could legitimately be performed using a number of different bases, including funding (Trustee view), accounting or a neutral basis. We expect that firm's should select the most appropriate basis for their own assessment. Could the PRA clarify their expectations for the basis to be used for a firm's own assessment?

We note that pension surpluses are de-recognised for Pillar 2A pension obligation risk capital calculation purposes but that deficits are included. We assume that surpluses should be stressed under Pillar 2A, and the resulting Pillar 2A requirement should be derived from the surplus or deficit that results from the Pillar 2A stress.

It would be helpful were the PRA to expand on the expectation of the analysis required for the risk of increased pension loss near the point of resolution as part of the ICAAP, which we do not think should be under Pillar 2 assessment which is based on a going concern assumption. The assessment of risk near resolution should in our view be covered as part of the discussions around firms' recovery and resolution plans and strategies.

It would be useful to understand how the Pillar 2B pension risk component interacts with Pillar 2A, especially for firms choosing to adopt a funding basis in Pillar 2A.

We think that clarity is required in relation to the deferred tax treatment assumed in the quantification of the Pillar 2A charge.

Finally, in relation to the request for capturing data under Section 75 valuation of liabilities - we assume this would only apply to UK schemes (i.e. organised under UK law), can the PRA confirm this?

Pillar 2B

The PRA buffer

We would welcome more transparency from the PRA on the calculation of the PRA buffer. Appendix 3, chapter 9 contains rationale and high level descriptions of the various factors involved, but we would expect a clearer and more detailed articulation. For example, how will the PRA be taking leverage ratio considerations in the calculation of the PRA buffer?

How will the PRA reflect a firm's systemic importance in its PRA buffer assessment?

It is not clear from the consultation that a firm's G-SIB and CCB buffers would be allowed to unconditionally offset against the PRA buffer (with the exclusion of the RM&G scalar, which if applied would always be additive); the wording "potential overlap" and "in some instances" in paragraphs 9.6 and 9.7 of appendix 3 give rise to ambiguity.

Is the utilisation of the PRA buffer, at the complete discretion of the firm, or, subject to some regulatory conditions? We would welcome further clarity from the PRA in this respect.

We believe that there is a potential to double count with Pillar 2A op risk charge?

The capital conservation and systemic buffers are phased in from 2016. So in 2016 firms will still be subject to a CPB but will also have CRD IV buffer requirements.

To avoid firms having to hold capital twice to cover the same risks, we would expect the PRA to clarify the transition from CPB to a PRA buffer, and in particular we would expect firms to be notified that their existing CPB will be offset by any CRD IV buffers as they are phased in, pre any PRA buffer assessment.

Interest Rate Risk in the Banking Book

We note that the PRA is not seeking comments on the (unchanged but not previously made public) methodologies for Interest Rate Risk in the Banking Book (IRRBB), market risk and counterparty risk. However this is the first time that the PRA publishes its methodology used to assess firms' capital requirements and we would like to offer our comments to this very important and current topic for the industry and regulators. The management of IRRBB has received little in the way of specific guidance from supervisory authorities hence we appreciate this clarification from the PRA on its approach to assessing IRRBB for capital purposes.

The PRA methodology is predominantly based on a VaR approach, a risk metric that naturally lends itself best to trading book activities where market traded prices are available and daily mark to market valuation is applied (and back testing of the metric is possible). Banking book activities are managed and should be viewed on an on-going concern, hold to maturity basis. This is the fundamental differentiating factor between a banking book and a trading book from which the differing accounting and regulatory treatments stem. The objection to the break up economic value approach applies only to genuine banking book activities – i.e. customer product balances, their hedges, the bank's own capital and its hedging, and any other specifically designated strategic hedges of perceived structural risk. The one year holding period is justified based on the illiquidity of the banking book, book instruments, but this should not be confused with the time required to hedge the interest rate risk which in most cases will be considerably shorter than one year.

We also note that the PRA's Pillar 2 approach to market risk covers trading and AFS books. In this case, can the PRA confirm the intended approach of the AFS book under IRRBB and whether the assessment will result in double counting of the risks?

The PRA outlines that 'IRRBB is the risk of losses arising from changes in the interest rates associated with banking book items.' We would like to confirm this definition and stress the difference between variability risk and loss risk whereby variability risk means that a risk metric is sensitive to a change in interest rates and loss risk means a loss of capital. For instance, future net interest income can depend on future interest rates, i.e. there is net interest income variability risk, without creating loss risk. This is a fundamentally different from the interest rate risk in the trading book where variability risk and loss risk are the same since transactions are accounted for their economic value since their inception. Hence, a decrease in a trading transaction's economic value leads to loss.

The PRA methodology for IRRBB in the ICAAP covers re-pricing risk, yield curve risk, basis risk and risks arising from embedded optionality; as well as change in assumptions e.g. those relating to customer behaviour. It would be helpful if the PRA could clarify if this implies that internal capital should be allocated for changes in assumptions. Banks should also measure the exposure and sensitivity of its available-for-sale and fair value exposures to yield curve risk and basis risk; and the earnings volatility (over 3 to 5 year timeframe). The reference to fair value exposure seems to be accounting standard-driven. It would be helpful if the PRA could clarify if this is a correct interpretation.

The PRA methodology covers Basis risk and states: 'Basis risk is generated by banking book items that re-price in relation to different reference rates. The most common and material basis risks seen within UK banks derive from products re-pricing against policy rates (e.g. Bank Rate) and market rates (e.g. Libor). As part of the review of basis risk the PRA also considers asset swap spread risk, which typically arises when firms hedge the duration risk associated with fixed rate securities using derivatives (typically interest rate swaps).' It is highly debatable that asset swap spread risk is considered in IRRBB. This should be referred to as Credit Spread Risk in the Banking Book (CSRBB), whist ensuring that capital is not double counted.

Responsible executive

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