Pillar 2A: Reconciling capital requirements and macroprudential buffers

BSA response to PRA CP 2/20

30 April 2020

Building Societies Association

Summary

The proposals in CP 2/20, while no doubt well-intentioned, are – unfortunately- seriously discriminatory to BSA members – as the CP itself has clarified. We urge the PRA to pause, reconsider, and if necessary come up with fairer and more even handed proposals. We make a couple of specific suggestions at the end of our response below.

Introduction

The original proposals in CP 2/20 followed through what was foreshadowed in December 2019 when the FPC announced a recalibration of the Countercyclical Buffer (CCyB) in a standard risk environment and a consequential increase 12 months later in the actual CCyB from 1% to 2%.

At the time, the FPC was clear that it should leave the overall loss-absorbing capacity (capital plus bail-inable debt) in the banking system broadly unchanged, specifically to *"ensure the banking system can support the wider economy through financial and business cycles"*, expecting *"overall capital requirements for **major UK banks*** (sic) *to remain broadly flat in the coming period."*

The BSA immediately protested at the discriminatory nature of the outline offset proposals in a letter to the PRA on 17 December 2019. As has subsequently been clarified in CP 2/20, we pointed out that the benefit of offset would be partly or wholly denied to the majority of societies, for one of two reasons – either because they are already leverage constrained ; or because they have no, or a negligible, remaining variable P2A component in the first place. CP 2/20 provides the necessary confirmation in paragraph 3.23 : only 14% of societies would receive the full offset benefit ; 38% would receive partial benefit, while 48% of societies – nearly half the sector by number (but, given the known impact on large leverage constrained societies, a massively higher proportion by total assets) – receive no benefit whatsoever.

Original proposals

In our December letter we appreciated why the FPC desired to increase the level of CCyB corresponding to a standard risk environment (and, consequently, double the actual CCyB) – this was well-argued and reasonable (though, as it proved, untimely). It was also reasonable in principle to avoid sharp shocks to the banking sector by seeking to mitigate the impact of the actual CCyB change so that overall regulatory capital would not see a significant step increase.

But this should have been achieved without such overt (if unintended) discrimination against building societies. At the time we also suggested to the PRA that a similar objective could have been achieved by more gradual implementation of the actual CCyB resulting from the recalibration. Instead of increasing capital buffers by a full 1% (before offset) within 12 months, the same increase could have been phased in over at least two years, at a rate more consistent with the natural rate of accretion of building society reserves – and no offsetting would have been necessary.

Changed context: COVID-19

The context of the original CP 2/20 proposals has now changed utterly. First, as of 11 March 2020 the FPC -as an emergency measure- not only reversed the December 2020 increase in the CCyB, but actually reduced the CCyB to zero, further stating[1] that no increase would take effect before March 2022 at the earliest. Then and subsequently, other measures have had to be announced, with the common purpose of conserving available capital headroom – either by mitigating automatic increases in capital resulting from mechanistic application of provisioning, or by constraining banks from distributing dividends or paying bonuses.

---

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

For the time being, therefore, the exact calibration of the CCyB is entirely academic, and the immediate necessity for an offset mechanism through Pillar 2A has also disappeared, as there will be nothing to offset for two years. The effective question for the PRA, therefore, is whether to proceed with the original CP 2/20 proposals and hand a discriminatory windfall mostly to riskier banks, or to pause and reflect in the overall changed context. In our view, there is likely to be value in waiting to see how buffers are best rebuilt in the post-Covid world rather than committing now to a course of action.

The fundamental reason why the offset mechanism fails the fairness test, and moreover appears counter productive in risk management terms, is that it favours – *ex hypothesi* – large universal banking models, and other riskier banks, with large variable Pillar 2A add-ons (which capture other risks not (or not adequately) catered for under Pillar 1). Building societies do, and are required by law to, specialise in the lower-risk asset class of residential mortgages. The largest societies, using internal models, are as a result - actually or prospectively -leverage constrained. Other societies have no, or very little, variable P2A as PRA already accepts that the Pillar 1 capital charge for the residential mortgage book embodies excess conservatism. So, unfortunately, the offset proposal entailed a policy choice to disadvantage one prudent and essential business – mortgage lending – in favour of other business models.

Alternative way forward

In the completely changed circumstances of COVID-19, how should PRA proceed? First, we urge a pause for reconsideration: there is no need to proceed now with the original proposals – as there is no CCyB to offset for at least two years, the anticipated need to avoid a step increase in regulatory capital falls away. So the Pillar 2A offset mechanism can be either withdrawn, or at the minimum, deferred until March 2021. But we consider PRA needs to have a wider, holistic re-think in the changed context, taking account of other capital relief measures, and taking on board our own observations about the toxic linkage with MREL. The previous piecemeal approach, which risked neglecting unwanted interactions, has run its course.

In the unprecedented times we currently face, a holistic, cumulative view is more necessary than ever : Basel 4 has been postponed by a year, and even its substance is now widely being questioned ; the EU is moving to provide quick fixes on awkward provisions of CRR ; there are calls also to delay or review MREL implementation ; and all regulators are scrambling to undo the procyclical havoc[2] that IFRS 9 would otherwise wreak. The PRA is considering the longer-term impacts on deposit-takers, and has already persuaded the large listed banks into cancelling their dividends and senior executive bonuses.

All of these argue for the PRA to take more time to reflect and, if possible, come up with a non-discriminatory approach to offsetting the CCyB recalibration. We have two suggestions for consideration,

First, for simplicity, the Bank /PRA could drop the offset idea, and through the FPC, slow the eventual resumption of CCyB build up to the new 2% norm, so taking care not to jeopardise any post-COVID recovery. For example, CCyB could be set to increase to no more than 0.5% in March 2022, 1.0 % in March 2023, and by a further two annual steps to 2% by 2025. If the recovery takes much longer to materialise, or is much weaker than expected, these dates can be postponed. Banks and building societies should be able to meet this timetable through existing capital conservation measures, but without either capital issuance or deleveraging.

Second, if the offset idea is to go ahead, then PRA can mitigate the evident unfairness as regards leverage-constrained firms – in our case those large societies that (as MREL firms) are indirectly subject to twice the leverage ratio through the toxic and iniquitous MREL formula. At present the FPC has already revised the leverage ratio upwards once – from 3.00 % to 3.25 % when "compensating" for the exclusion of central bank deposits – so, 0.25% above the level mandated both in Basel 3 and in CRR 2. This gives the Bank /PRA scope to offer partial equivalent offset to leverage constrained bank and building societies.

[2] See, for instance, PRA's oral evidence to Treasury Committee, 15th April at Q187 .

The December FPC announcement raised both the main Basel- and EU-mandated CCyB (based on RWAs), and the Bank's own construct of the Countercyclical Leverage Buffer (CCLB) – the latter from 0.4% (rounded from 0.35%) to 0.70%. Using the Bank's own coefficient of 0.35% to relate leverage and risk based capital requirements, and the same argument that a higher level of standard-environment resilience should be reflected in a reduction in minimum requirements already covering the same risks, the Bank/PRA could reduce the current and prospective leverage ratio minimum from 3.25% to 3.10 %, closer to other jurisdictions. The 0.15% release would largely though not completely balance the 0.35% increase in the CCLB.

Conclusion

We urge the Bank / PRA to use the time until we return towards a standard risk environment to step back, take stock, and come up with a fairer package to accompany the CCyB recalibration that does not appear to reward the riskier firms and, in relative terms, penalise those prudent firms - like building societies -who are moreover committed to supporting residential mortgage borrowers through the COVID crisis. The BSA, and leading societies, will be happy to engage further with the PRA to discuss the suggestions above.

Jeremy Palmer
Head of Financial Policy
jeremy.palmer@bsa.org.uk
020 7520 5912

York House
23 Kingsway
London WC2B 6UJ

020 7520 5900
@BSABuildingSocs
www.bsa.org.uk

BSA EU Transparency Register No: 924933110421-64

www.bsa.org.uk

The Building Societies Association (BSA) is the voice of the UK's building societies and also represents a number of credit unions.

We fulfil two key roles. We provide our members with information to help them run their businesses. We also represent their interests to audiences including the Financial Conduct Authority, Prudential Regulation Authority and other regulators, the Government and Parliament, the Bank of England, the media and other opinion formers, and the general public.

Our members have total assets of over £420 billion, and account for 23% of the UK mortgage market and 19% of the UK savings market.