RETAIL BANKING INQUIRY

Summary of hearing with the Prudential Regulation Authority (PRA) on 25 August 2015

The capital framework

1. The PRA described the capital framework, which is set at international level by the Basel Committee on Banking Supervision. This framework is given legal effect in the EU through the terms of the EU Capital Requirements Regulation (CRR) and Directive (CRD IV). The PRA has transposed CRD IV into UK law through its Rules and Supervisory Statements. CRR is a maximum harmonising regulation, which means that the PRA does not have discretion in its implementation – ie it cannot go further (or less far) than the terms of the Regulation – except where permitted by the Regulation.

2. The PRA explained that the Basel framework was set with the main prudential objectives of safety and soundness in mind. The original framework was established in the period when competition impact assessments did not feature prominently in the EU as standard practice. However, the PRA did not feel that there was any significant tension between a prudential objective and a competition objective. From a competition perspective, one would want banks to be properly holding capital against their risk as this would ensure they compete with the right incentives and have greater ability to manage their risk.

3. The EU had a single market objective and its impact assessments typically benchmark the level of competition across member states rather than focus on competition within each member state, as well as being subject to considerable data constraints.

4. The PRA noted that supervisory responsibilities within the EU have recently changed with the systemically important Eurozone banks now regulated under the Single Supervisory Mechanism (SSM)[1].

[1] This is a group of 28 supervisors comprising the European Central Bank and the national competent banking authorities of participating Member States.

Risk weights

The risk-based capital framework

5. The PRA discussed the process by which capital risk weights are set using either the internal-ratings based (IRB) approach or the standardised approach.[2]

6. The PRA explained that both approaches had their pros and cons and could affect competition in different ways. There was no single best approach that could perfectly proxy risk under real-world conditions with data limitations. Banks inherently differed in terms of their business and asset mix. A standardised approach could disadvantage banks where the credit risk exposure was concentrated towards the lower end of the risk spectrum. An IRB approach could better reflect the actual risk inherent to a bank's activities but could lead to issues to the extent that not all firms are capable of developing those models or would consider it economic to do so (due to regulatory requirements on the amount of data they must produce to move to an IRB model, and cost); and there is a potential for gaming and inconsistencies in modelling approaches.

7. There was a mix of views across the international community as to preferences. The PRA considered that there was a role for IRB models if properly applied and in particular circumstances: for example risk variation across jurisdictions is likely to be higher on a mortgage book than on sovereigns and a risk model will therefore be of more value in the former case.

The IRB approval process

8. The PRA explained that the requirements for a bank to become IRB-approved are prescribed in the CRR. It must grant permission where these are met, although it has scope to exercise judgement in some areas where the law requires banks to satisfy the regulator on qualitative criteria.

9. The PRA said that the requirements aim to establish a degree of confidence that the firm can effectively use the model in its business, can understand the results of the model and can demonstrate the predictive strength of the model.

[2] Under the Basel framework, the amount of capital banks are required to hold varies according to the risk of its underlying activities/assets (risk-weighted assets (RWA)). Banks have two ways of estimating the risk weights to apply: by using their own internal risk models (the IRB approach) or by using average risk weights set by the regulator (the standardised approach).

10. A bank would therefore need to have the appropriate governance in place, and to be able to define the model parameters appropriately, in order to move to an IRB approach. Under EU law the use of the IRB approach was conditional (among other factors) on a minimum of five years' historical data and three years of model usage. There was a possible exemption to reduce the former requirement to a minimum of two years – however, incoming European Banking Authority (EBA) technical standards were expected to remove this discretion. More than five years' historical data may be required in practice to accurately estimate model parameters across an economic cycle.

11. Another requirement was for all asset classes to be modelled once IRB approval is obtained (so-called 'full use'). This was designed to prevent banks cherry-picking certain assets where they would get an advantage from using a bespoke model but keeping other assets on the standardised approach. However, the PRA recognised this could also have disadvantages in that it forces banks to model risk for asset classes where they may not have the ability to model it very well.

12. Internationally, it had been found over past years that there was significant variation in some of the risk-weights being estimated by IRB models, even under hypothetical portfolio exercises where the same assets were given to banks to model. The requirements in place for IRB approval are aimed at safeguarding the quality of banks' risk models.

The potential impact on competition

13. The PRA recognised that at the level of individual asset classes the use of different approaches to calculate risk-weights led to some imbalances between competing banks. While there will naturally be some gap between the IRB and standardised approaches – indeed this is desirable to incentivise investment in risk management – the PRA considered that the most significant gaps may be wider than appropriate:

    (a) Currently the widest gap can be observed in relation to low loan-to-value mortgages.

    (b) On SME lending the PRA observed some difference between the outcomes under the standardised and the IRB approach but it was not as large as for mortgages (specifically, mortgage asset classes with loan-to-value ratio below 70%).

14. While on individual asset classes newer banks may be disadvantaged by their reliance on the standardised approach, overall after taking into account the steps taken, particularly since the financial crisis, to increase capital

requirements for more systemically important large banks (for example, higher capital buffer requirements, stress testing and leverage ratio requirements), the PRA considered that the effect was less clear.

(a) The PRA explained that capital buffers are an innovation since the financial crisis. Prior to the crisis the PRA had essentially set a minimum requirement. From 2015 to 2019 the buffers that are required of larger banks globally will become progressively higher than for smaller banks; and from 2019 the buffers required of UK ring fenced banks and large building societies will be higher than for smaller banks.

(i) Since the crisis, the PRA had been more prescriptive about what it regards as an acceptable buffer and assesses this for each bank using a five year stress test. The PRA explained that all firms undergo stress testing, but the testing is more extensive and the criteria more stringent for the larger firms.

(ii) The Basel Committee had also introduced additional buffers. These have been transposed into EU law, with the minimum requirement increasing from a floor of 2.5 percentage points of total assets weighted for risk (RWA) depending on the systemic importance of the bank.

(iii) Legislation had been passed in the UK requiring the ring-fencing of the retail operations of systemically important UK banks and this will also introduce higher buffers for the ring-fenced banks by 2019.

(b) A leverage ratio was also being introduced. In general the leverage ratio only binds if a firm is doing a significant amount of business at the lower-risk-weight end. That, typically, means mortgage banks. To the extent that banks and regulators do not necessarily know whether the bank's business is genuinely low risk, the leverage ratio offers a backstop against the under-estimation of risk, or another way of measuring risk. Having a regime with a leverage ratio and a risk-weighted ratio as well as stress testing was more robust than relying on only one way of measuring risk.

15. These measures were part of a move, since the financial crisis, towards making regulation proportionate not only to the probability-of-failure risk but also the economic impact of that failure. That had made the regime more complex but, hopefully, better addresses the potential for market failure (ie damage to the economy which goes beyond the damage to the shareholders, particularly when large firms fail). There are a number of strands to this policy:

(a) Resolution policy, making it possible to recapitalise banks, when they fail, from their bondholders rather than from the government; and/or if necessary for exit to occur in an orderly way so as to limit any associated economic damage. Ring-fencing was a key part of this as, by restructuring banking groups when solvent, it will make it possible to break them up following failure.

(b) Making it less likely in the first place that the systemically important banks experience financial stress. This essentially meant holding them to a higher standard on capital requirements, using for example the additional buffers previously discussed.

16. Although these measures did not strictly correct for any underlying discrepancies between RWA approaches, once they had taken effect the overall capital requirement for the whole of the business of the bank was likely to be higher for a large bank than a small bank, notwithstanding the fact that the marginal capital requirement for a particular loan may be higher on the standardised approach for a new entrant that does not have an IRB model.

17. Nevertheless, the PRA said that both it and the international community are in favour of narrowing the larger gaps between the IRB and standardised approaches where appropriate and feasible, both by improving bank use of IRB models and improving the calibration and risk sensitivity of standardised risk weights.

18. The PRA was also at the early stages of exploring the extent to which, it could be made more feasible for new entrants to develop IRB models.

Ongoing Basel Committee initiatives relating to risk weights

19. The PRA noted that the Basel Committee was seeking to address some of the issues with the risk-weighting framework, for example through the Committee's review on the standardised approach. The PRA supported the direction of that work, which is subject to ongoing discussions at international level, and would argue for a more risk-sensitive standardised approach than currently. The PRA had encouraged market participants to give their feedback on the proposals and a number of comments had been received and were being considered.

20. Further, the PRA noted ongoing work on the potential application of an IRB capital floor, which could also reduce the differential between the standardised and IRB approaches.

The role of the PRA and its competition objective

The role of the PRA

21. The PRA noted that the strategic agenda for prudential matters is set at international level and by the UK government, in light of the importance of such matters to the economy. It explained that the government leads on the introduction of legislation and it provides an advisory function to government.

22. In this function, the PRA has a role to play in influencing global policy-making through its representation of the UK in numerous forums including at the Basel Committee. The PRA is regularly in contact with the European Commission and other regulators in Europe, as well as the EBA, the SSM and the European Central Bank. The PRA takes the lead for the UK within the EBA, where it participates in numerous working groups which input into developing regulatory technical standards and guidelines. The EBA proposals are voted on by the Board of Supervisors and hence strongly influence the implementation of the law.

The PRA's competition objective

23. The PRA discussed the competition objective that had been assigned to the PRA at its incarnation. The PRA noted that this is a secondary objective that can only be applied when pursuing their primary regulatory objectives. The PRA explained that it considers competition alongside its paramount objectives of prudential safety and soundness. Accordingly it sought to ensure that the rules applied for this latter purpose do not inadvertently create problems for competition where this can be avoided and, by ensuring that firms take risk properly into account, to minimise distortions to firms' incentives to compete. Its role and tools therefore enable it to facilitate rather than create competition.

24. The PRA considered that its prudential and competition objectives will generally tend towards a similar outcome, as prudential regulation aims to correct market failure by better aligning the risk of failure with the impact of failure and the interests of society. This should in turn enable competition in markets to work more effectively. The main risk of distortion to competition through this process stems from imperfect data, in that regulators must rely on proxies to assess risk.

25. Under its secondary competition objective the PRA is in the early stages of considering the aspects of prudential regulation that could inhibit competition, whether by deterring entry or competition among incumbent firms. The main elements where this could occur were:

(a) Proportionality of regulation. The PRA cited their application of Pillar 2[3] for smaller firms as an example of seeking to be proportionate where possible. Pillar 2 allows firm-specific capital adjustments and was an area in which the PRA did have some flexibility, since within the maximum harmonising framework there was still scope for supervisory judgment to take account of firms' specificities. For example, the PRA noted that it has excluded residential mortgage exposures from the calculation of credit concentration limits – which would benefit smaller firms that are focused on mortgages.

(b) Too-big-to-fail advantages for larger firms. This is an aspect the PRA had been addressing, for example through the introduction of systemic buffers and ring-fencing as previously discussed.

26. The PRA explained that when introducing new regulation, it would conduct a competition impact assessment, engage with industry and consult on impact and analysis. For example, in response to its recent consultation on Pillar 2 methodology the PRA highlighted that it had adapted its approach so that supervisors may now exercise judgement for small firms where they identify that the credit concentration risk methodology could overstate risks.

Variation in approach by country

27. When asked whether there are differences in international approaches to capital requirements, the PRA explained that the US has chosen to apply its capital requirements according to bank size, subject to minimum requirements. The EU approach, with a single market objective, generally treats firms equally regardless of size. However, the EU is currently consulting on whether some greater flexibility in the application of the capital regime would be appropriate. The PRA noted the risks of creating further distortions by treating different types of firms differently but, subject to this caveat, would support work to develop a simpler, more flexible regime for smaller banks.

28. More generally it noted that any changes to the capital framework would need to be cascaded to the UK via various international and legislative levels and would therefore be gradual.

29. The PRA explained that its role is mainly focused on implementation of EU legislation rather than on drafting the terms of that legislation. Nevertheless, in some areas which are not covered by European harmonising law the PRA had taken its own approach which in some cases anticipated EU

[3] Pillar 2 is intended to ensure that firms have adequate capital to support the relevant risks in their business, and that they have appropriate processes to ensure compliance with CRD IV.

requirements and sought where appropriate to take firm differences into account. For example:

(a) The leverage ratio would, at least initially, apply only to the biggest firms because they are the firms whose failure is of most concern because the impact of their failure would be greater. The PRA planned to review its wider application in 2017 in light of an international approach.

(b) Structural reform (ring-fencing) is a UK initiative, although there is a European proposal for structural reform which is somewhat different. The PRA was working with industry to implement the legislation. Related to this it was considering the potential competition impact of the legislation.

(c) The PRA had recently clarified, and published rules on, their approach to Pillar 2 and this differs somewhat from other areas of Europe. The PRA explained that this approach takes a number of small firm considerations into account. For example, residential mortgage portfolios on the standardised approach are not included in geographic credit concentration risk assessments and this approach can benefit those banks on the standardised approach.

30. The PRA considered there would, increasingly, be a differentiation in the supervision of EU banks of different sizes, simply because systemically important banks were now being supervised by the SSM, as although this supervision is being conducted within the same law there was, as discussed, some degree of supervisory judgement involved.

The new bank authorisation process

31. The reforms introduced to streamline and enhance the process of becoming authorised as a bank, in which the PRA liaises closely with the Financial Conduct Authority (FCA) but acts as the lead within this process for dual-regulated firms (including all deposit-taking institutions), were discussed.

32. The PRA confirmed that feedback on the reforms had been positive. In particular it felt that the opportunity to have early pre-application discussions had been beneficial and valuable to potential entrants as they developed their initial thinking about the viability of their potential business model and about the services they might wish to provide. It was helpful to firms who could otherwise lack visibility of the information requirements and the regulatory process. A significant number of firms have taken up the opportunity.

33. The PRA confirmed that it continues to work closely with the FCA to ensure the efficiency of the dual-regulated authorisation process and to consider

further potential enhancements. One example was the work the PRA was carrying out with the FCA to establish the new bank unit announced by Government this summer.[4] The objective of the unit was to provide additional support for new banks to progress through the authorisation process. The PRA and FCA have started planning the unit's programme of work, with consideration being given to firms' needs through the end to end process: from pre-application, to the early stages of authorisation, through to completion of the process.

Ring-fencing

34. The PRA explained its role in establishing the rules necessary to implement the ring-fencing legislation passed by government in response to the recommendations contained in the Independent Commission on Banking's report. This legislation aims to separate the retail banking functions of systemically important UK banks from the rest of their group entity so that the retail bank can function as an independent bank without significant financial, managerial or operational dependencies on other parts of the group.

35. For this purpose, the affected banks will have to restructure as a holding company with core banking subsidiaries. This would help make banks more resolvable both by ensuring recapitalisation can occur at holding level (which is less disruptive) and by creating separate legal entities (which can reduce contagion and facilitate recovery in the event of a crisis). From a capital perspective, it was clearly envisaged by legislation that the ring-fenced banking subsidiaries should be more resilient and will accordingly be subject to higher capital requirements. One of these requirements would be the systemic risk buffer previously discussed (see paragraph 14). The Financial Policy Committee of the Bank of England (FPC) will need to consider the methodology for calibrating this buffer, which under legislation enacted by HM Treasury can be set up to a maximum of 3% of RWAs of the ring-fenced bank.

36. Banks were expected to take different approaches depending on the nature of their organisation, for example the scope of their activities and their international reach. While ring-fencing would involve major reorganisation for banks, it was less clear what impact, if any, it would have on the services provided to customers. The PRA said that it had considered the competition implications of its proposed policy, and had sought to ensure its ring-fencing requirements are consistent with effective competition. For example, the PRA had examined whether there are some groups of customers who may be

[4] See *Fixing the foundations: creating a more prosperous nation*.

more affected, for example mid-market corporates who can use both retail and investment banking services.

37. An extensive programme of engagement with industry was underway as the banks work to implement the rules. The PRA explained that it was about to publish a substantial body of material for consultation in order to clarify and confirm the requirements and it will continue to do so in the run-up to full implementation.

Cost of funds

38. The PRA explained that as part of the PRA's monitoring of the viability of a bank's business model, it looks at the bank's ability to generate profits relative to its cost of equity. The funding cost is one element of this.

39. The PRA noted that banks' cost of funds was dependent on their mix of wholesale and retail funding, and the nature of the retail funding. The macro-economic environment since the financial crisis had also played a large part. Pre-crisis, banks had relied on the margin between the risk-free rate and the deposit rate as one source of profit. As the risk-free rate fell, and funding costs rose, they had to build an asset margin to compensate and recently this margin had been compressed, largely by competition on some assets.

40. Clearly, a bank with a large current account book would have a lower cost of funds than a bank that was relying on either wholesale market funding or competing for retail funding in deposit accounts or more interest-rate-sensitive retail accounts.

41. The PRA's regulatory activities could affect the cost of funds in two main ways: through actions taken to protect deposits and actions to make banks more resolvable.

   (a) Deposit protection should tend to equalise to a greater extent the cost of funds, particularly for interest-rate sensitive funds. [✂].

   (b) At the wholesale end, the work done by the PRA on resolvability should ensure that wholesale lenders to a bank see themselves at risk if that bank fails and, therefore, would be sensitive to the underlying risk of the bank. To the extent that the PRA can make it credible that bondholders would be bailed in, ie converted to equity in the event of resolution of a bank, then that distortion should go away because they will not see themselves as risk free. Significant progress had been made in this regard, as testified by ratings agencies taking steps to amend its ratings for government support. However, further work remained to be done, for

example via the implementation of ring-fencing (see paragraphs 344 to 377).

42. The PRA noted, however, that even after these measures have taken effect it would not necessarily be the case that small banks have the same cost of funds as large banks as there are other factors which may influence that cost of funds, for example, diversification in assessments of the underlying strength of the banks. Obviously, to the extent that regulatory policy requires bigger banks to be more resilient because the impact of their failure is greater, then they may have a lower cost of funds and that could arguably be seen as a fair outcome.