BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

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Dear Harriett

I am writing to provide you with an update on some of the key pieces of work the PRA is undertaking in pursuit of our secondary competition objective. There are two main themes that I wanted to draw your attention to. Firstly, the approach we are taking to prospective revisions to the European Capital Requirements Regulation (CRR) and Capital Requirements Directive (CRD) where we are advocating a more proportionate application of these requirements. Secondly, the work we are doing within the PRA to review the process of applying for credit risk Internal Ratings Based (IRB) models.

European Commission legislation review

The European Commission has recently closed its public consultation process on the impact of the Capital Requirements Regulation (CRR) and Capital Requirements Directive (CRD IV) on bank financing of the economy. It also sought views on the case for greater differentiation, or simplification, of regulation across the banking sector.

The Bank's response, which is now public (see attached), focused on the case for greater proportionality in the regulatory regime. The EU, unlike a number of other large jurisdictions, applies broadly the same set of rules to all its "credit institutions". The goal of this approach is to deliver safety and soundness in the financial system, achieve a level playing field and thus help complete the Single Market. But this "one size fits all" approach of common binding rules that doesn't differentiate by the size or complexity of an institution leads to a high cost of regulation for smaller firms which can cause market distortions. The Bank's view is that policy makers need to weigh the desirability of a single rule book for all firms with wider objectives, including growth, financial stability and effective competition.

To this end the Bank has advocated a differentiated approach that would have two key benefits. Firstly it would allow the EU to align the regulation of larger banks more closely with global standards, thus supporting financial stability. Secondly, and importantly, it would allow a more proportionate approach to be taken applying international standards, which are rightly set with large banks in mind, to smaller banks and building societies.

Examples of areas where a more proportionate approach could be adopted include: the so-called Net Stable Funding Ratio liquidity requirement; narrowing the gap between the capital requirements delivered by the use of internal models and standardised approaches, particular for credit risk; and reporting requirements.

The Bank is of the view that a more proportionate approach could help foster greater competition without any material negative impact on financial stability and that this would be good for the European Single Market.

PRA's approach to credit risk Internal Ratings Based (IRB) model approvals

Since the financial crisis the PRA has spent a great deal of time ensuring that where banks are able to use so-called internal models to calculate their capital requirements these models meet robust standards. This focus has been entirely right in my view, and has led to a toughening of the internal models regime.

Given what we have learnt we will consider whether our approach to the internal credit model application process could be made more proportionate for smaller banks and building societies. In considering any changes we will not, as you would expect, compromise safety and soundness or undermine the need for robust credit risk management standards. It will also be important to be mindful of ongoing work by the Basel Committee to improve the standardised approach which in itself aims to make the standardised approach more risk sensitive and narrow the gap between modelled and standardised requirements. These changes should deliver an improved standardised approach which delivers more balanced outcomes.

In considering our approach to internal credit model applications we will need to act within the existing constraints of the CRR/CRD pending any revision.

As part of our efforts to ensure there is a level playing field we are planning to organise seminars for smaller banks. The aim of these seminars is to ensure that all banks have a clear understanding of the necessary modelling standards that we expect them to meet.

I will update you on our progress in the coming months and the PRA's first annual competition report will provide an assessment of the work we have done.

Yours Sincerely

Andrew Bailey Andrew