



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

The Rt Hon Andrew Tyrie MP
Chairman
Treasury Committee
House of Commons
14 Tothill Street
London
SW1H 9NB

Andrew Bailey
Deputy Governor, Prudential Regulation
CEO, Prudential Regulation Authority
T 020 7601 4293
andrew.bailey@bankofengland.co.uk

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Dear Andrew,

Thank you for your letter regarding the disclosure of average capital ratios. Your letter asks whether it is possible to provide average capital ratios for the incumbent lenders, alongside those of new entrants, to help Parliament and the public to quantify whether there is a competitive disadvantage under which new banks operate.

Whilst the concept of comparing average capital requirements for groups of financial institutions appears to be straightforward, it is far more complex in practice. There are also issues of confidentiality in what the PRA can disclose for individual banks. That said, I have sought in this letter to provide a full account illustrated with stylised but nonetheless realistic, examples.

The bottom line is that it is typical for there to be a difference in capital requirements between those institutions using internal modelling approaches (IRB) and those using the standardised capital approach (SA) which would be the more normal approach for a new entrant or smaller firm. However, it is important to note that the difference is not as large as is often suggested, particularly once other capital requirements, such as the leverage ratio, are taken into account. In addition, while IRB modelled capital requirements are often lower than the standardised approach, firms using modelled approaches are required to have more sophisticated risk management capabilities, which of course carry their own cost.

As you are aware, we are putting considerable effort and resource into international policy discussions to reduce the differential between the two approaches where appropriate. We touched on this at the recent hearing on European issues where I welcomed the so-called Call for Evidence approach being used by the European Commission to identify issues in the regulatory framework. I hope that this exercise will lead to sensible modifications of the regime.

Marginal Capital Comparison

In order to compare the marginal regulatory capital impact of lending on a particular asset class between the two approaches, we need to look at three key parts of the capital requirement. These are: the leverage ratio; the various (and new) capital buffers in Basel 3/CRDIV; and the fact that firms have different business models and asset exposures which will attract different capital requirements and which is relevant for this purpose because there are effects from the mix of assets on overall capital requirements.

In order to present this in as simplified and directly comparable way as possible, I have set out the marginal capital requirements in extending a standard £1000 70% loan-to-value (LTV), prime UK residential mortgage for a smaller UK lender on SA versus a monoline mortgage lender using IRB. This comparison is set out below. However, please note that in order to generate such a comparison, there are a large number of assumptions that have been applied. I have sought to set out these assumptions in the footnotes.

The leverage ratio framework provides a floor to the very low risk weights that can be produced by internal capital models. These models are not necessarily wrong in an empirical and theoretical sense, but they produce uncomfortably low risk weights, the effect of which we offset via the leverage ratio and stress tests. The leverage ratio complements the risk-based capital framework by requiring all lenders to fund their assets with a minimum amount of capital. In effect, as calibrated it sets a floor on an average risk weight basis of around 35% across the balance sheet, which happens to be equivalent to the current standardised risk weight for residential mortgages.

Table A

£ Marginal capital / £1000 mortgage	Lender on SA – risk weight constrained	Monoline Lender (IRB or SA) – leverage constrained
Pillar 1	28.00	30.00
Capital Conservation Buffer (CCB (@ 2.5% RWAs)	8.75	n/a ¹
Systemic Risk Buffer (@ 1.25% RWAs) ²	n/a ³	4.38
Counter Cyclical Buffer (CCYB (assuming 1% RWAs) ⁴	3.50	3.50
Total	40.25	37.88

¹ This is not applicable because there is no comparable Leverage-based buffer for the Capital Conservation Buffer.

² This is the mid-range of the options presented in the recent Consultation Paper published 29 January 2016 http://www.bankofengland.co.uk/financialstability/Documents/fpc/srbf_cp.pdf

³ This is not applicable because, the Systemic Risk Buffer does not apply a capital requirement to institutions with total assets under £175bn.

⁴ We have used 1% as that is the expected “market normal” level of the CCYB as published in the Financial Stability Report’s outlook for the Medium Term Capital Framework (page 15) <http://www.bankofengland.co.uk/publications/Documents/fsr/2015/fsrsupp.pdf>

The SA UK lender's marginal capital requirement is driven by the risk weight and buffers approach. The average risk weight for lower loan-to-value, prime residential mortgages under the SA is 35%, implying a £28.00 Pillar 1 requirement⁵. The FPC's leverage ratio framework does not currently apply to institutions outside the major UK lenders but, even if it did, the lender in this stylised example would not be constrained by leverage as the overall risk-weighted requirement bites first.

For the large monoline lender, the capital constraint in lending to the same mortgage borrower will be based on the leverage ratio, rather than the lower risk weighted requirement generated under the IRB approach. If we compare the Pillar 1 element which forms the largest part of the minimum capital requirement, the SA form has a slightly lower capital requirement.

Next, I have added in two buffers that will always be present in the new regime, namely the Capital Conservation and Countercyclical buffers. The effect is to tip the balance slightly towards the IRB firm, but again there is not much in it.

That is not the end of the story however, because a further important comparison is between the two above cases and the same mortgage loan advanced by a large, diversified lender on IRB. This is set out below.

Table B

£ Marginal capital / £1000 mortgage	Diversified IRB Lender – risk-weight constrained
Pillar 1	10.16
Capital Conservation Buffer (CCB (@ 2.5% RWAs)	3.18
Systemic Risk Buffer (@ 1.25% RWAs)	1.59
Counter Cyclical Buffer (CCYB (assuming 1% RWAs)	1.27
Total	16.20

In this case the marginal capital requirement is likely to be driven by risk weights and the capital buffers, not the leverage ratio. This is because the lender's business model is sufficiently diversified into a number of different asset classes, not just prime residential lending. The risk weights in these other asset classes tend to be significantly higher than those for prime residential mortgage lending (for example higher risk weights in corporate lending, equity exposures and unsecured retail exposures). Therefore, for a diversified major lender, these exposures tend to lead to higher risk weights and a capital requirement that exceeds the requirement driven by the leverage ratio, particularly when capital buffers are also taken into account. The diversification of the balance sheet is key for these types of lender. The way to think about this is that the higher risk weight lending carries the higher equivalent risk weight of the leverage ratio as applied to the prime mortgage loan, and thus the leverage ratio does not bite.

⁵ Where 8% is the Pillar 1 capital requirement, so **£1000** (loan amount) x **0.35** (risk weight) x **0.08**.

However, there will be a tipping point where the leverage ratio becomes the binding constraint and this is likely to occur the more the large diversified lender expands into lending that attracts lower risk weights (such as low LTV prime residential lending in our stylised example).

This is important because it means that the more a diversified lender decides to switch into low risk weight assets such as prime mortgages, the more likely it is to have the leverage ratio as the binding constraint. Turning again to the buffers, this lender will also need to maintain the Systemic Risk Buffer. The consequence of all this is that the large diversified lender has an advantage over both the other stylised firms, but not by as much as is claimed based on a comparison only of risk weights.

Forward Looking Agenda

The implementation of the FPC's binding leverage ratio has therefore resulted in a significant levelling of the playing field in terms of Pillar 1 capital requirements between the two categories of firms highlighted in Table A, a point recognised by the Competition and Markets Authority. Nevertheless, the difference evident in Table B illustrates why we are taking a leading role in discussions internationally to deliver a more level playing field between the two approaches (SA and IRB). This is of course, consistent with our competition objective.

We have also taken other steps:

- **PRA buffer (Pillar 2B):** lenders are expected to hold additional equity capital in the form of a PRA buffer to cover losses that may arise under a severe but plausible stress scenario. The PRA applies a more flexible approach to new entrants and expanding smaller lenders when setting the PRA buffer while holding systemically important institutions to a higher standard given the greater impact of their failure on the wider economy.
- **Additional buffers for systemic importance:** Lenders with total assets above £175bn will be set progressively higher systemic risk buffer (SRB) rates as total assets increase through defined buckets. The Government required the FPC to produce a framework for the SRB at rates between 0% and 3% of RWAs. Under the FPC's proposals, ring-fenced bank sub-groups and large building societies in scope with total assets below £175bn will be subject to a 0% SRB. Based on current information, under these proposals the FPC expects the largest ring-fenced bank in 2019 to have a 2.5% SRB. In line with the FPC's previous announcement on the leverage ratio framework, those institutions subject to the SRB will also be set a 3% minimum leverage ratio requirement, together with an additional leverage ratio buffer calculated at 35% of the applicable SRB rate.

For example, an institution with an SRB rate of 1% would have an additional leverage ratio buffer of 0.35%. The proposed calibration is expected to add around 0.5 percentage points of risk-weighted assets to the equity requirements of the system in aggregate. The FPC intends to finalise the framework by 31 May 2016. The buffer will apply from 2019.

There is much still to be done and we are committed to seeking international agreement on further reducing the differential in overall capital requirements provided it is done so in a way that does not compromise our primary objective of safety and soundness. Work is under way in Basel to revise the SA and introduce greater risk sensitivity that will more closely align the IRB and SA approaches, and thus narrow the differential.

In addition, work is underway in relation to constraining IRB modelling (for example where it is deemed that models do not assess risks sufficiently prudently). The PRA is also looking at whether more can be done to assist lenders wishing to transition to the IRB model approach.

Furthermore, the Bank is committed to developing proportionality at a European level and has published its written response to the European Commission's call for evidence on the subject. This advocates explicitly the need for a more proportionate regulatory regime and discussions are continuing.

I would conclude by emphasising that it is important not to define the debate too narrowly and only focus on capital requirements. Capital requirements are not the only driver in determining the benefits of extending a mortgage. The pricing of a mortgage is not just a function of the regulatory capital requirement: it also depends on the funding cost, the cost of hedging and holding liquidity, and the assumptions on how the borrower may behave (i.e. buying other products).

I hope that this letter provides you with the clarity required. Please let me know if you have any further questions.

Yours sincerely

A handwritten signature in black ink that reads "Andrew Bailey". The signature is written in a cursive, slightly slanted style.

Andrew Bailey