



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Consultation Paper | CP39/15

The PRA's approach to identifying other systemically important institutions (O-SIIs)

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Responses are requested by 18 January 2016.

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1 Overview

1.1 In this consultation paper (CP), the Prudential Regulation Authority (PRA) sets out the criteria and scoring methodology it proposes to use to identify other systemically important institutions (O-SIIs). These criteria and methodology are derived from Article 131(3) of the Capital Requirements Directive (2013/36/EU) (CRD) – which requires O-SIIs to be identified¹ – and follow the European Banking Authority (EBA) Guidelines on the criteria to determine the conditions of application of Article 131(3) CRD in relation to the assessment of O-SIIs.²

1.2 This consultation is relevant to credit institutions, investment firms and European Economic Area (EEA) parent (mixed) financial holding companies incorporated in the United Kingdom. The proposals contained in this consultation do not apply to EEA and third-country branches operating in the UK.

Background

1.3 In addition to measures that increase the resilience of global systemically important banks, the Financial Stability Board has recommended that national authorities identify domestic systemically important banks (D-SIBs) and take measures to reduce the probability and impact of the distress or failure of D-SIBs – including higher loss absorbency requirements, intensive supervision and resolution requirements. The Basel Committee on Banking Supervision has established a framework for D-SIBs.³ The CRD contains the EU implementation of these accords in its provisions regarding O-SIIs (the equivalent of D-SIBs under EU legislation) and the systemic risk buffer.

1.4 The proposals in this CP are intended to identify and designate as O-SIIs those firms whose distress or failure would have a systemic impact on the UK or the EU economy or financial system due to size, importance (including substitutability or financial system infrastructure), complexity, cross-border activity, and interconnectedness.

1.5 Under the UK government's current implementation of the CRD, O-SIIs are not required to maintain additional capital buffers (O-SII buffers).

1.6 The UK government has implemented higher loss absorbency requirements for D-SIBs via the systemic risk buffer (SRB), which applies only to SRB institutions. These are defined in the Capital Requirements (Capital Buffers and Macro-Prudential Measures) Regulations as ring-fenced bodies, and building societies that meet the equivalent of the £25 billion core deposits threshold for ring-fencing. These regulations require the Financial Policy Committee (FPC) to specify criteria and a scoring methodology for measuring the systemic importance of SRB institutions, and to map scores to SRB rates of 0%, 1%, 1.5%, 2%, 2.5%, and 3% of risk-weighted assets.⁴ The FPC will consult on and publish its criteria and methodology for the systemic risk buffer by 31 May 2016. The PRA must apply the FPC's criteria and methodology, derive the corresponding SRB rate, and set an SRB for each SRB institution from 1 January 2019.

Consequences of O-SII designation

1.7 The PRA proposes to identify O-SIIs in the United Kingdom each year in accordance with the methodology set out in relevant EBA Guidelines, and will publish the outcome of the

1 Article 131(3) of the CRD is implemented in the UK by the Capital Requirements (Capital Buffers and Macroprudential measures) Regulations 2014 (SI 2014/894)

2 EBA/GL/2014/10

3 www.bis.org/publ/bcbs233.pdf

4 www.legislation.gov.uk/uk/si/2015/19/pdfs/uksi_20150019_en.pdf

annual O-SII identification assessment, including a list of the firms identified as O-SIIs (O-SII designation).

1.8 Where EBA Guidelines give the PRA discretion over parts of the O-SII identification methodology, the PRA proposes aligning O-SII identification with its existing potential impact framework. Set out in the PRA's approach to banking supervision¹, the potential impact framework classifies firms into different categories of systemic importance to help the PRA determine the appropriate level of supervisory intensity for a firm – see Appendix 1. It reflects a firm's potential to affect adversely the stability of the system by failing, coming under stress, or the way it carries on its business.

1.9 Given the proposed O-SII identification methodology, institutions designated as O-SIIs will be subject to enhanced supervision by the PRA, including recovery and resolution planning, in line with the current supervisory approach to 'Category 1' firms. Overall, the PRA therefore expects the O-SII framework to have limited impact on firms. The PRA may further enhance its supervisory approach towards O-SIIs in future.

Proposals under consultation

1.10 The PRA is consulting on a draft of the statement of policy on the PRA's approach to identifying O-SIIs - see Appendix 1. The statement sets out the criteria and scoring methodology that the PRA will use to identify O-SIIs under the CRD. In particular, it consults on the following areas:

- (i) which firms can be identified as O-SIIs;
- (ii) application of discretion afforded within the EBA's mandatory scoring methodology for O-SII identification;
- (iii) application of a supervisory overlay to adequately capture systemic risk in the UK banking sector, and proposals to use the methodology of the PRA's existing potential impact framework to inform this assessment; and
- (iv) the timetable for O-SII identification, and publications related to O-SII identification.

Statutory obligations

1.11 The proposals are compatible with the PRA's statutory objectives under the Financial Services and Markets Act 2000 (FSMA): to promote the safety and soundness of PRA-authorized firms;² focusing on the adverse effects that they can have on the stability of the UK financial system.

1.12 When determining the general policy and principles by reference to which it performs particular functions, the PRA must have regard to the regulatory principles.³ Of particular relevance in this circumstance are the principles relating to proportionality, the need to use the resources of the regulator in the most efficient and economic way, the desirability where appropriate of each regulator exercising its functions in a way that recognises differences in the nature of, and objectives of, business carried on by different firms the PRA authorises and the principle that the regulators should exercise their functions as transparently as possible.

¹ PRA Supervisory Approach: www.bankofengland.co.uk/pr/Pages/supervision/approach/default.aspx

² See s.2B(1) and s.2B(2) FSMA.

³ See s.3B FSMA.

1.13 The approach to O-SII identification and the ensuing supervisory approach set out in this CP ensure that the O-SII framework will fit into the current supervisory approach in a way that minimises additional burden on firms. It will also enable the PRA to focus its resources on those firms whose distress or failure has adverse effects on the stability of the UK financial system and will ensure that the PRA's approach is transparent to market participants and the general public.

Impact on competition

1.14 When determining the general policy and principles by reference to which it performs particular functions, the PRA is legally required, so far as is reasonably possible, to facilitate effective competition in the markets for services provided by PRA-authorised persons in carrying out regulated activities.¹

1.15 The PRA concludes that the proposals in this consultation paper facilitate effective competition. Systemically important institutions have in the past benefitted from government support in the event of failure and from expectations of government support, weakening market discipline and incentivising management to take greater risks. By identifying O-SIIs and making them subject to enhanced supervision, including recovery and resolution planning, the PRA can ensure that O-SIIs compete in a way that does not compromise their safety and soundness and thereby have adverse effects on other financial institutions and the real economy. This also enables other institutions to enter and compete in the markets for services provided by PRA-authorised persons in a way that does not compromise their safety and soundness.

Economic impact

1.16 The PRA does not consider that O-SII identification will have a direct economic impact on firms. The ensuing enhanced supervisory approach will not be a significant departure from existing supervisory procedures and intensity. So O-SII designation will not increase costs to firms designated as O-SIIs.

Equality and diversity

1.17 In making its rules and establishing its practices and procedures, the PRA must have regard to the Regulatory Principles as set out in the Financial Services and Markets Act 2000 (FSMA).² The PRA may not act in an unlawfully discriminatory manner. It is required, under the Equalities Act 2010, to have due regard to the need to eliminate discrimination and to promote equality of opportunity in carrying out its policies, services and functions.³ To meet this requirement, the PRA has performed an assessment of the policy proposals and does not consider that the proposals give rise to equality and diversity implications.

Impact on mutuals

1.18 FSMA requires that the PRA assesses whether, in its opinion, the impact of the proposed rules on mutuals will be significantly different from the impact on other firms.⁴ The PRA is not proposing new rules and does not consider that the impact of the proposals in the draft statement of policy on mutuals will be significantly different from the impact on other firms, as the same assessment criteria and scoring methodology will be applied to all types of firms. As this methodology assesses a range of activities, some of which are not performed by mutuals to a significant extent, there is no reason to believe that this methodology should overestimate the systemic importance of mutuals.

1 See s.2H FSMA.

2 See s.2H and s.3B FSMA.

3 Equalities Act 2010, section 149(1).

4 Section 138K of FSMA.

Responses and next steps

1.19 This consultation closes on 18 January 2016. The PRA invites feedback on the proposals set out in this consultation. Please address any comments or enquiries to CP39_15@bankofengland.co.uk.

1.20 Following consideration of the consultation responses, the PRA will publish the statement of policy on the PRA's approach to identifying O-SIIs, and the list of O-SIIs in the first quarter of 2016. Thereafter, the PRA proposes to conduct O-SII identification annually and publish the list of firms designated as O-SIIs by 1 December each year.

Appendices

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- 1 Draft Statement of Policy: The PRA's approach to identifying other systemically important institutions (O-SIIs)**

Appendix 1: Statement of Policy – The PRA's approach to identifying other systemically important institutions (O-SIIs)

1 Introduction

1.1 This statement of policy sets out the criteria and scoring methodology that the Prudential Regulation Authority (PRA) will use to identify other systemically important institutions (O-SIIs), as is required under the Capital Requirements Directive (2013/36/EU) (CRD) as implemented in the Capital Requirements (Capital Buffers and Macro-prudential measures) Regulations 2014.¹

1.2 In developing its approach to the identification of O-SIIs, the PRA has taken into consideration the European Banking Authority (EBA) Guidelines on the 'criteria to determine the conditions of application of Article 131(3) of Directive 2013/36/EU (CRD) in relation to the assessment of other systemically important institutions (O-SIIs)', referred to in the following as 'the EBA Guidelines'.² The PRA has stated to the EBA that it intends to comply with these Guidelines.

1.3 The EBA Guidelines set out an O-SII identification process consisting of two stages. The first stage is a minimum mandatory framework, which consists of a prescribed set of criteria, indicators and weights that authorities should use to identify the institutions that must be designated as O-SIIs. The second stage offers authorities the discretion to overlay the mandatory part of the framework in order to better reflect the specificities of the national banking sector, and if appropriate, designate additional firms as O-SIIs. The PRA has chosen to exercise this discretion and use its potential impact framework (see section 4 and appendix 1) to align the definition of O-SIIs broadly with its existing 'Category 1' firms, whose disorderly failure would have the highest impact on the UK financial system and economy.

2 Which firms can be identified as O-SIIs?

2.1 In line with the CRD and EBA Guidelines, the framework outlined in this statement of policy is to be applied in relation to all credit institutions, investment firms, and EEA parent (mixed) financial holding companies within the domestic financial sector at their highest level of consolidation in the United Kingdom.

2.2 The framework is not applied to: i) EEA and third-country branches of overseas firms, ii) investment firms not regulated by the PRA, and iii) firms holding less than 0.02% of the total assets of UK credit institutions and investment firms. The rationale for this is as follows:

- (i) The CRD does not allow the designation of third country and EEA branches of overseas banks as O-SIIs. Therefore these institutions are not considered for O-SII designation. In line with the EBA Guidelines, the PRA, however, includes the activity of UK branches of overseas banks in the denominators used for calculating indicator scores.
- (ii) The framework is only applied to those investment firms designated for prudential supervision by the PRA. The Statement of Policy 'Designation of investment firms for prudential supervision by the PRA'³ outlines the PRA's designation policy, which takes into

1 www.legislation.gov.uk/uksi/2014/894/contents/made

2 www.eba.europa.eu/documents/10180/930752/EBA-GL-2014-10+%28Guidelines+on+O-SIIs+Assessment%29.pdf

3 www.bankofengland.co.uk/publications/Documents/other/pradesignationofinvestmentfirms.pdf

account the criteria of size, substitutability, interconnectedness, and complexity; the same criteria set out in article 131(2) CRD and the EBA Guidelines. Therefore, if an investment firm has not been designated for supervision by the PRA, this means that the PRA has assessed that the investment firm is not systemically important. This assessment is sufficient to comply with the O-SII assessment methodology set out in the CRD and the EBA Guidelines.

- (iii) The PRA uses the discretion provided in the EBA Guidelines to exclude firms from the identification process which - at their highest level of consolidation in the UK - hold less than 0.02% of the total assets of credit institutions and investment firms authorised in the UK. Estimates of these firms' activity are included in the denominators used for calculating indicator scores.

3 EBA's mandatory scoring methodology for O-SII identification

3.1 Under the mandatory element of the EBA Guidelines, O-SIIs should be identified based on a score calculated using the categories, indicators and weightings set out in Table 1. Data item definitions are provided in the EBA Guidelines.

Table 1: Mandatory indicators and weightings according to the EBA Guidelines

Category	Indicator	Weight (%)
Size	Total assets	25.00
Importance (including substitutability/financial system infrastructure)	Value of domestic payment transactions	8.33
	Private sector deposits from depositors in the EU	8.33
	Private sector loans to recipients in the EU	8.33
Complexity/ cross-border activity	Value of OTC derivatives (notional)	8.33
	Cross-jurisdictional liabilities	8.33
	Cross-jurisdictional claims	8.33
Interconnectedness	Intra-financial system liabilities	8.33
	Intra-financial system assets	8.33
	Debt securities outstanding	8.33

3.2 The PRA calculates each relevant¹ entity's mandatory score by:

- (i) dividing the indicator value of each individual relevant entity by the aggregate amount of the respective indicator values summed across all institutions in scope of this framework, authorised in the UK (the 'denominators');
- (ii) multiplying the resulting percentages by 10,000 to express the indicator scores in terms of basis points;
- (iii) calculating the category score for each relevant entity by taking a simple average of the indicator scores in that category; and

¹ As outlined in section 2 of this Statement of Policy.

- (iv) calculating the overall score for each relevant entity by taking a simple average of its four category scores. Therefore, the final score can be interpreted as a firm's weighted average market share across the activities contributing to systemic importance, measured in basis points.

3.3 EEA and third-country branches of overseas banks are not assessed as part of this framework, but estimates of their activity are included in the denominators. As set out in section 2, the PRA also uses its discretion to exclude firms with a share of less than 0.02% of UK firms' total assets from the framework, but includes estimates of their activity in the denominators.

3.4 Under the EBA Guidelines, the default cut-off for being automatically designated as an O-SII is 350 basis points. The Guidelines provide national discretion to raise or lower this threshold by 75 basis points. The PRA has chosen not to exercise this discretion.

4 The PRA's supervisory overlay – the potential impact framework

4.1 In addition to the mandatory scoring methodology, the EBA guidelines request that national authorities should assess whether further firms should be designated as O-SIIs based on the mandatory indicator scores, or on additional qualitative and/or quantitative indicators of systemic importance. National authorities can select indicators that adequately capture systemic importance for their domestic economy or the EU economy from the list in Annexes 1 and 2 of the EBA Guidelines.

4.2 The PRA will use the quantitative methodology of its existing potential impact framework (as set out in the PRA's approach to banking supervision¹) to inform its assessment of whether further firms should be designated as O-SIIs. All quantitative indicators of systemic importance used in this framework which are relevant to credit institutions and investment firms are available under the EBA Guidelines. The potential impact framework complements the EBA's mandatory scoring methodology by measuring activities that are critical to the UK economy and financial system, in line with the PRA's focus on the risk of disruption to the continuity of supply of critical economic functions.

4.3 The potential impact framework classifies firms into different categories of impact to help the PRA determine the appropriate level of supervisory intensity for a firm. This framework reflects a firm's potential to affect adversely the stability of the system by failing, coming under stress, or the way it carries on its business. This effect can take place through two broad channels – the first is directly, through the impact on real economic activity or on the soundness of other participants, and so the provision of financial services to the economy as a whole. The second is indirectly, through behavioural effects where vulnerabilities within one firm affect confidence in other firms with similar business models or products.

4.4 The PRA judges that the credit institutions and investment firms classified as 'Category 1' under the potential impact framework should be designated as O-SIIs in the UK, unless they have been classified as 'Category 1' firms only because of their activity conducted in the United Kingdom through EEA and third-country branches of overseas firms. The PRA's approach to banking supervision document defines 'Category 1' firms as the most significant deposit-takers and designated investment firms whose size, interconnectedness, complexity and business type give them the capacity to cause very significant disruption to the UK financial system (and through that to economic activity more widely) by failing or by carrying on their business in an

¹ www.bankofengland.co.uk/pr/Pages/supervision/approach/default.aspx

unsafe manner. The scale of such adverse effects depends both on the functions a firm provides, and its significance within the financial system. Some of the critical economic functions that firms provide are: payment, settlement and clearing; retail banking; corporate banking; intra-financial system borrowing and lending; investment banking; and custody services. The scale of a firm's potential impact also depends on its size, complexity, business type and interconnectedness with the rest of the financial system. The part of the potential impact framework used in O-SII identification – namely the indicators and weightings that are relevant to banks and investment firms, rather than to insurers - is set out in Appendix 1.¹

4.5 The PRA calculates the firms' supervisory overlay scores based on the indicators set out in Table 1 of Appendix 1, in line with the calculation method outlined in paragraphs 3.2 and 3.3. This score will then form the basis for the PRA to use judgment on whether to designate firms as O-SIIs. Under the current potential impact framework, all Category 1 firms that are subject to O-SII assessment have scores exceeding 100 basis points. Therefore the PRA expects to designate firms whose supervisory overlay score exceeds 100 basis points as O-SIIs.

4.6 There are cases in which the PRA may designate firms as O-SIIs whose supervisory overlay score is below 100 basis points.

- (i) Firms scoring just below 100 basis points that have been designated in the previous year may be designated as O-SIIs if the PRA judges that they are systemically important to the UK or the EU economy.
- (ii) The quantitative elements of the O-SII assessment methodology are applied at the highest level of consolidation in the UK, but some subsidiaries of overseas groups do not have a single consolidation in the UK. Where one of the subsidiaries has been designated as an O-SII, the PRA can use supervisory judgement to designate any of its sister subsidiaries in the UK as O-SIIs, if interdependencies between the subsidiaries mean that the resilience of the O-SII could be threatened by the failure of a sister subsidiary.

4.7 If the potential impact framework is changed in future, this may also require the threshold to be changed, and this statement of policy to be updated accordingly.

5 O-SII identification timetable and publication

5.1 The PRA will conduct the O-SII identification annually and publish the list of firms designated as O-SIIs by 1 December each year. It will also publish:

- (i) The mandatory score of each firm designated as an O-SII under the EBA's mandatory O-SII scoring methodology.
- (ii) The supervisory overlay score of each firm designated as an O-SII under the supervisory overlay. If the supervisory overlay score of a firm designated as an O-SII does not exceed 100 basis points, the PRA will publish the rationale for designating this firm.

¹ The PRA also applies the potential impact framework to insurance firms. Therefore the framework also includes indicators relevant to insurance firms. These indicators are not used for O-SII identification.

Appendix 1: The PRA's potential impact framework

In the PRA's potential impact framework,¹ a firm's potential impact score is calculated based on its significance in a number of categories (eg 'retail banking'). A firm's significance in each category is measured as the firm's share of PRA-regulated firms' activity. A number of indicators (eg 'value of retail deposits') measure a firm's activity within each category. The market shares in each indicator are averaged within categories using the weights outlined in the fourth column of Table 1. Subsequently, the overall potential impact score is calculated by averaging across the categories using equal weights.

Table 1: Categories and indicators to be used in the supervisory overlay

Category	Category weight (%)	Indicators	Weight within category (%)
Retail Banking	100	Value of Retail Deposits	44
		Value of Retail Lending	23
		Number of Retail Customers	33
Corporate Banking	100	Value of Corporate Deposits	60
		Value of Corporate Lending	40
Intra-financial Banking	100	Intra-financial Liabilities (Deposits, Repos, Derivatives)	50
		Intra-financial Assets (Loans, Reverse Repos, Derivatives)	50
Payment, Settlement & Clearing services	100	Daily Average Value of CHAPS transactions	35
		Daily Average Value of BACS transactions	15
		Daily Average Value of CREST transactions	35
		Daily Average Value of LCH transactions	15
Custody Services	100	Custody assets	100
Investment Banking	100	Trading Assets	50
		Market transaction volumes	50

Retail and corporate banking, and retail payments activities reflect the direct impact that the distress or failure of a systemic institution could have on the UK economy through the disruption or cessation of services. The larger an institution's market share in these services, the less substitutable it is. The indicators selected to inform these criteria of systemic importance reflect the different types of transactions the financial institutions can have with the retail and corporate sectors.

The remaining criteria (intra-financial banking, settlements and clearing, custody services, investment banking) reflect other direct and indirect channels through which the distress or failure of institutions could pose a threat to the real economy, including through other intermediaries.

¹ The PRA also applies the potential impact framework to insurance firms. Therefore the framework also includes indicators relevant to insurance firms. These indicators are not used for O-SII identification.