



BANK OF ENGLAND  
PRUDENTIAL REGULATION  
AUTHORITY

Consultation Paper | CP19/17

# Groups policy and double leverage

October 2017





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Responses are requested by Thursday 4 January 2018.

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## 1 Overview

1.1 Most international banking groups comprise many legal entities, regulated and unregulated, in multiple jurisdictions. As a result, the UK regulatory regime for banks includes prudential requirements relating both to individual legal entities ('firms') that undertake regulated activities such as deposit taking<sup>1</sup> in the United Kingdom,<sup>2</sup> and to the broader groups of which they form a part. The broader group context is important as the financial position of a firm may be adversely affected by its relationships with other entities in the same group or by risks that affect the financial position of the whole group, including reputational contagion. 'Groups policy' refers to the PRA's framework for assessing and mitigating these risks.

1.2 The PRA has reviewed the groups policy framework, in order to ensure that it remains coherent and fit for purpose in light of post-crisis financial reforms – including Basel III standards, UK ring-fencing legislation, the resolution framework and other international developments. Following the review, the PRA is considering some necessary changes to achieve this objective.

1.3 This consultation paper (CP) makes proposals that require:

- assessment and mitigation of the risks to group resilience due to the use of 'double leverage'.<sup>3</sup> Double leverage occurs when one or more parent entities in a group funds some of the capital in its subsidiaries by raising debt or lower forms of capital externally (Chapter 2);
- assessment and mitigation of the risks highlighted by prudential requirements applied by local regulatory authorities<sup>4</sup> on overseas subsidiaries of UK consolidation groups (Chapter 2); and
- improved monitoring of the distribution of financial resources across different group entities (Chapter 3).

1.4 In order to implement the above proposals, the PRA proposes to update:

- Supervisory Statement (SS) 31/15 'The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)';<sup>5</sup>
- Statement of Policy 'The PRA's methodologies for setting Pillar 2 capital';<sup>6</sup>
- SS24/15 'The PRA's approach to supervising funding and liquidity risk';<sup>7</sup> and
- Internal Capital Adequacy Assessment Part of the PRA Rulebook.

1.5 The PRA is also consulting elsewhere on a number of other policy proposals that refine the PRA's framework for groups policy. They are summarised in Chapter 4.

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1 Regulated activities are defined in The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001.

2 Some of these entities may be dual-regulated together with the Financial Conduct Authority.

3 For the purpose of this CP, double leverage is referred to as a parent company's Common Equity Tier 1 (CET1) capital investment in its subsidiaries divided by its own CET1 capital.

4 A 'local regulatory authority' refers to a regulatory authority outside the United Kingdom that is responsible for the regulation of subsidiaries established in its jurisdiction.

5 February 2017: [www.bankofengland.co.uk/pr/Pages/publications/ss/2017/ss3115update.aspx](http://www.bankofengland.co.uk/pr/Pages/publications/ss/2017/ss3115update.aspx).

6 February 2017: [www.bankofengland.co.uk/pr/Pages/publications/sop/2017/p2methodologiesupdate.aspx](http://www.bankofengland.co.uk/pr/Pages/publications/sop/2017/p2methodologiesupdate.aspx).

7 December 2016: [www.bankofengland.co.uk/pr/Pages/publications/ss/2016/ss2415update.aspx](http://www.bankofengland.co.uk/pr/Pages/publications/ss/2016/ss2415update.aspx).

1.6 This CP is relevant to PRA-authorized UK banks, building societies, PRA-designated UK investment firms and their qualifying parent undertakings (QPU),<sup>1</sup> as well as credit institutions, investment firms and financial institutions that are subsidiaries of these firms, regardless of their location.

1.7 The Bank of England is currently consulting on internal minimum requirements for own funds and eligible liabilities (MREL).<sup>2</sup> The two CPs, together with proposals related to the groups policy framework being consulted on elsewhere,<sup>3</sup> provide an update to the existing policy framework on the distribution of financial resources in banking groups, the calibration of requirements for individual group entities and the treatment of intragroup relationships in both going and gone concern. They should provide clarity to firms as they define their group resource allocation strategies to meet the expectations of post-crisis financial reforms.

### Groups policy framework

1.8 The PRA applies prudential standards to firms on an individual and consolidated basis. This means that firms are required to meet prudential requirements on the basis of their individual balance sheets, and in respect of the aggregate balance sheet of all entities within their UK consolidation group.<sup>4</sup>

1.9 Individual and consolidated requirements are separate but complementary. Both are needed for effective supervision and to promote the PRA's general objective of safety and soundness of firms.

- Individual requirements take into account both the external and intragroup risks faced by a firm to mitigate the risk to the firm's safety and soundness.
- Consolidated requirements ensure that a banking group holds the appropriate amount and quality of financial resources to cover the risks of the whole group, including those parts that are not subject to individual requirements.
- Consolidated requirements do not capture intragroup transactions, which would otherwise lead to double counting of financial risks and resources when considering the group as a whole.
- Taking a group level view allows the PRA to understand the risks to the UK financial system originating from its banking groups. Where the PRA is the global consolidating supervisor, this allows the PRA to fulfil its responsibilities to the global financial system under the Basel Accord.

1.10 When setting individual and consolidated requirements, it is important to consider the calibration and application of those requirements in the context of the groups' business

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1 Qualifying parent undertaking has the meaning in section 192B of the Financial Services and Markets Act (FSMA) 2000 which, in summary, is a UK parent undertaking of a PRA-authorized person or an investment firm. As contained in the FSMA Act 2000 (Prescribed Financial Institutions) Order 2013, the definition of QPUs includes financial holding companies and mixed financial holding companies.

2 Internal MREL - the Bank of England's approach to setting a minimum requirement for own funds and eligible liabilities (MREL) within groups and further issues: Consultation on a proposed updated Statement of Policy, October 2017: <http://www.bankofengland.co.uk/financialstability/Documents/resolution/mrelconsultation2017.pdf>

3 See PRA Consultation Paper 12/17 'Pillar 2A capital requirements and disclosure', July 2017: [www.bankofengland.co.uk/pra/Pages/publications/cp/2017/cp1217.aspx](http://www.bankofengland.co.uk/pra/Pages/publications/cp/2017/cp1217.aspx); PRA Consultation Paper 13/17 'Pillar 2 Liquidity', July 2017: [www.bankofengland.co.uk/pra/Pages/publications/cp/2017/cp1317.aspx](http://www.bankofengland.co.uk/pra/Pages/publications/cp/2017/cp1317.aspx); and PRA Consultation Paper 20/17 'Changes to the PRA's large exposures framework', October 2017: <http://www.bankofengland.co.uk/pra/Pages/publications/cp/2017/cp2017.aspx>

4 Firms subject to structural reform (Ring Fenced Bodies or 'RFBs') will, in addition, be required to meet prudential requirements on a sub-consolidated basis (i.e. in respect of the RFB sub-groups' balance sheets).



models and intragroup relationships. For example, where appropriate, the PRA will recognise the benefits to individual entities of being part of a wider group when setting individual requirements. On the other hand, risks could arise due to the group's business model that may not be adequately captured in the group's current consolidated requirement. In these instances, the PRA may consider adjusting the group's consolidated requirement to reflect these risks.

1.11 The PRA's overall approach to groups policy, and its review of the existing policies, has been guided by four principles:

- (i) *Banking groups should be resilient:* Consolidated banking groups should have appropriate financial resources to cover the risks of the whole group. The PRA expects firms to meet capital and liquidity requirements on a consolidated basis for groups headquartered in the United Kingdom and for UK sub-groups of wider global groups.
- (ii) *Resources should be located close to risks:* The financial resources required on a consolidated basis should be allocated appropriately between different entities in the group.<sup>1</sup> The PRA expects firms to meet capital and liquidity requirements on an individual basis (i.e. in respect of firms' individual balance sheets).
- (iii) *Risks of intragroup contagion should be limited:* Individual firms (and sub-groups) should limit their exposures to other entities (and sub-groups) in their groups. Within its own consolidation group, a firm is required to treat its exposures to other group entities as if they were exposures to a third party. Specifically, the Capital Requirements Regulation (CRR)<sup>2</sup> limits a firm's intragroup exposures to 25% of its eligible capital.<sup>3</sup>
- (iv) *Where appropriate, intragroup relationships should be recognised when setting prudential requirements on an individual basis:* The PRA takes into account the overall business model of the group and the strength of the firm's relationship with other entities in the group when setting its prudential requirements. For instance, the PRA may permit exemption of intragroup exposures greater than the large exposures (LE) limit where group entities are strongly incentivised to support each other and there are no impediments to the transfer of financial resources between the entities.<sup>4</sup> Where firms can demonstrate that liquidity can flow freely amongst the group entities,<sup>5</sup> the PRA may also waive the application of CRR liquidity requirements on an individual basis, and supervise firms and their subsidiaries established in the United Kingdom as a single liquidity sub-group (DoLSub).<sup>6</sup>

## Responses and next steps

1.12 This consultation closes on Thursday 4 January 2018. The PRA invites feedback on the proposals set out in this consultation. Please address any comments or enquiries to CP19\_17@bankofengland.co.uk.

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1 The PRA's approach to banking supervision (2016), Chapter 3, states that 'The PRA is mindful that capital resources are not always freely transferable around a group when it matters most. Therefore, the PRA expects capital to be located in the regulated entities where it is needed'. It also states that 'The PRA is mindful that liquidity resources are not always freely transferable around a group when it matters most. The PRA expects firms to take account of this in ensuring that liquidity is available without impediment to the regulated entities where it is needed, including in stressed times.'

2 Regulation (EU) No. 575/2013 (CRR).

3 Article 395(1) of CRR.

4 In accordance with Articles 113(6) and 400(2)(c) of CRR.

5 Firms will also need to meet other relevant conditions. See Article 8(2) of CRR.

6 See [www.bankofengland.co.uk/pradocuments/authorisations/waiverscrr/crrarticle8.pdf](http://www.bankofengland.co.uk/pradocuments/authorisations/waiverscrr/crrarticle8.pdf) for further details.

1.13 Once the proposals are finalised, the policy will be implemented fully from 1 January 2019. Where practical and applicable, firms should aim to incorporate the consultation proposals in their 2018 ICAAP/Individual Liquidity Adequacy Assessment Process (ILAAP) submissions ahead of full implementation.

1.14 The PRA will keep its proposed approach and policy under review to assess whether any adjustments are required. In particular, the PRA will monitor the quality of information provided by firms in their ICAAPs/ILAAPs in order to ensure it is sufficient to meet the expectations set out in these proposals.

1.15 The proposals in this CP have been designed in the context of the current UK and EU regulatory framework. The PRA will keep the policy under review to assess whether any changes would be required due to changes in the UK regulatory framework, including those arising once any new arrangements with the European Union take effect.

## **2 Group resilience**

2.1 This chapter summarises the PRA's approach to ensure that banking groups are appropriately resourced to cover the risks of the whole group. In that context, the PRA is putting forward proposals for firms to assess and mitigate the risks to group resilience stemming from double leverage and the differences between consolidated capital requirements and the aggregate requirements for individual group entities.

### **Appropriate financial resources within a group**

2.2 The PRA considers that the principle of appropriate financial resources to cover all the risks of a banking group is fundamental to ensuring its safety and soundness.

2.3 Concerns about the appropriateness and sufficiency of the group's financial resources may lead to adverse contagion risks spreading to individual entities within the group, including PRA-authorized entities. The latter may then, for example, experience liquidity outflows or difficulties raising funds, which may lead to their going concern viability being undermined.

### **Current PRA requirements and supervisory expectations on the sufficiency of financial resources within a group**

2.4 Firms must meet prudential requirements for capital and liquidity on a consolidated basis. Firms must meet these requirements by maintaining appropriate financial resources, both in terms of quantity and quality, taking into account all the risks to which the groups, which firms are members of, are exposed. This includes risks arising as a result of the activities of firms' subsidiaries and affiliated entities, which may not themselves be PRA-authorized entities.<sup>1</sup>

### **Risk to group resilience due to differences in prudential requirements at different levels of application**

2.5 The PRA applies prudential requirements to firms on an individual, sub-consolidated<sup>2</sup> and consolidated basis. Requirements applied at an individual (and sub-consolidated) level can, when aggregated, be higher than consolidated requirements because:

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<sup>1</sup> Article 11 of CRR and PRA Rulebook, ICAA Part, Rule 2.1 and ILAA Part, Rule 2.1.

<sup>2</sup> For firms subject to structural reform.

- individual (and sub-consolidated) requirements capture some risks that net off in the calculation of consolidated requirements. For example, intragroup exposures between a firm and other entities in its consolidation group are eliminated on consolidation. Similarly, some market risk positions of individual entities in the same consolidation group can be offset against one another for the purposes of calculating consolidated capital requirements; and
- individual (or sub-consolidated) requirements imposed by local jurisdictions are set in accordance with the regulatory frameworks in those jurisdictions. This can mean some subsidiaries in local jurisdictions are required to have proportionally more resources for a given risk than the consolidation group is required to have for the same risk.

2.6 The PRA considers that where the aggregate requirements for individual entities (or sub-groups) in a group are higher than the consolidated requirement for the group, action could be required to address the following prudential risks:

- The firm's QPU may use debt or capital other than CET1 capital to meet the above difference. This is known as double leverage.<sup>1</sup> Double leverage may weaken the resilience of holding companies and, in turn, PRA-authorized firms (see Box A).
- Higher local regulatory authority requirements reveal that the global consolidated requirements do not capture all of the group's risks. This could mean a consolidation group has insufficient resources overall.

## Proposals

### Double leverage

2.7 The PRA is proposing several expectations in order to address risks arising from excessive double leverage.

2.8 Where a firm's QPU uses double leverage, the PRA expects the firm to assess and mitigate the risks its QPU faces as part of its consolidated capital adequacy assessment.<sup>2</sup> As part of this, the PRA expects firms to demonstrate that their QPU is able to cover adequately its cash outflows in both normal and stress conditions. Specifically, the PRA expects the firm to report in its ICAAP submission:

- information on the QPU's actual and projected cash inflows and outflows under both normal and stressed conditions over a three-to five-year time horizon (set in line with the stress tests and scenario analyses performed by the firm as part of the ICAAP).<sup>3</sup> In particular, firms should consider any legal, regulatory or practical constraints that subsidiaries may face when making dividend payments or up-streaming funds to their QPU;
- any mitigating factors, such as stocks of unencumbered liquid assets held at the QPU; and

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1 Whilst double leverage generally occurs at the level of the top parent company within a consolidation group, it can occur at any level within a group. The focus is on the top financial holding company within a UK consolidation group for the purpose of this CP. Regulated parent entities are required to deduct significant investments in subsidiaries where those investments exceed thresholds set out in Article 48 of CRR. Any amounts not deducted are subject to a 250% risk weight. In practice, this prevents regulated parent entities from employing double leverage.

2 Firms for which the PRA is not the global consolidating supervisor are not expected to conduct this assessment or provide the relevant analysis in their ICAAP documents, unless the PRA requests otherwise.

3 PRA Rulebook, ICAA part, Rule 12.

- any actions that would be undertaken by its management in a stress to ensure the resilience of the QPU.

#### **Box A: Double leverage and associated risks**

The incentive to use double leverage arises because debt funding is generally more cost-efficient than equity capital. However, double leverage introduces payment and maturity mismatch risks ('cash-flow risks') for the holding companies:

- *Payment mismatch risk:* A holding company that has used double leverage will need to service the debt that it has raised. To meet these obligations, it will typically rely in part or in full on dividend income from its subsidiaries. Dividend income is uncertain. It is dependent on the subsidiaries' earnings performance and is payable at the discretion of the subsidiaries' boards. Dividend income could also be affected by restrictions imposed by regulatory authorities. This risk is mitigated if the holding company's income stream is sufficiently diversified. It may also hold buffers of cash or liquid assets to cover outflows in the event of shocks.
- *Maturity mismatch risk:* A holding company needs to re-finance term debt, but its equity investments are perpetual. It may mitigate maturity mismatch risk by phasing the maturities of their debt to avoid 'cliff edge' effects in any given year.

If managed inappropriately, these cash-flow risks can threaten the safety and soundness of PRA-authorized entities in the group as the latter are likely to suffer from adverse reputational contagion if their holding company becomes distressed. For example, there could be a risk of the PRA-authorized entity experiencing difficulties raising funds because market participants have concerns that problems elsewhere in the group could undermine the viability of the PRA-authorized entity. Holding companies using double leverage may also increase pressure on their subsidiaries to upstream dividends in order to service the external debt, weakening their underlying capital positions.

Market discipline already imposes some constraints on the amount of double leverage a holding company can use. Credit rating agencies (CRAs) take double leverage into account when determining the credit worthiness of holding companies. The PRA is aware that some CRAs would consider a double leverage ratio – measured as a holding company's investments in subsidiary equity capital divided by its own (unconsolidated) equity capital – above 120% to be a negative factor. CRAs may also consider the expected cash-flow coverage of the holding company and other relevant factors when making their rating decisions.

2.9 The PRA may set firm-specific double leverage limits if, after the Supervisory Review and Evaluation Process (SREP), it considers the level of risks to the group arising as the result of the

QPU's use of double leverage to be excessive. The PRA will consider the firm's mitigating factors and management actions when reviewing the firm's assessment of its QPU's risks.<sup>1</sup>

2.10 Under the Senior Managers Regime (SMR), firms are required to allocate a Prescribed Responsibility for managing the allocation and maintenance of the firm's capital, funding and liquidity to an individual performing a senior management function (SMF), typically the Chief Finance function (SMF2) or, depending on the organisational structure of a group, a Group Entity Senior Manager function (SMF7). In either case, the PRA expects the SMF who is allocated this Prescribed Responsibility to ensure that the assessment of the risk stemming from the QPU's use of double leverage is provided in the firm's ICAAP submissions and for this to be explicitly reflected in their Statement of Responsibilities.<sup>2</sup>

### Overall group resilience

2.11 In some circumstances, higher capital or liquidity requirements imposed by local regulatory authorities could reveal instances where consolidated group requirements do not fully or adequately capture all of groups' risks.

### Capital

2.12 If a group contains an entity established outside the United Kingdom that is subject to capital requirements for a risk that does not net off on consolidation, and that risk is not adequately captured in the consolidated capital requirements, the consolidated requirements may need to be increased to appropriately capture that risk.

2.13 To ensure groups have appropriate financial resources in respect of all risks to which they are exposed, the PRA proposes to set the following expectations of firms undertaking an ICAAP (see Appendix 1).

2.14 A firm should include in its ICAAP document:<sup>3,4</sup>

- the amount of any minimum capital requirements applied by local regulatory authorities for a specific risk category (e.g. credit risk, market risk or operational risk) that is higher than the amount of the minimum requirements set in respect of the same underlying risks at the consolidated group level; and
- the amount of any capital buffers applied by local regulatory authorities that are higher than the amount of the capital buffers applied for the same underlying risks at the consolidated group level.<sup>5</sup> This should include situations in which no buffer is applied in respect of a risk at the consolidated level.

1 The PRA has previously set out its expectation that the UK parent of an RFB should not make use of double leverage to fund its investment in an RFB or other entities in an RFB sub-group. (See PRA Policy Statement 20/16 'The implementation of ring-fencing: prudential requirements, intragroup arrangements and use of financial market infrastructures': [www.bankofengland.co.uk/pr/Pages/publications/ps/2016/ps2016.aspx](http://www.bankofengland.co.uk/pr/Pages/publications/ps/2016/ps2016.aspx)). To implement this expectation and to comply with the FPC recommendation on systemic buffers, the PRA will take account of RFB group risk when assessing capital adequacy at the consolidated group level under Pillar 2 to ensure that sufficient capital of appropriate quality is held within, and distributed appropriately across, the consolidated group to cover the risks faced by the RFB sub-group itself and, separately, group entities that are not members of the RFB sub-group. The methodology to address RFB group risk is set out in SS31/15 and Statement of Policy 'The PRA's methodologies for setting Pillar 2 capital'.

2 See PRA Supervisory Statement 28/15 'Strengthening individual accountability in banking', May 2017: [www.bankofengland.co.uk/pr/Pages/publications/ss/2017/ss2815update.aspx](http://www.bankofengland.co.uk/pr/Pages/publications/ss/2017/ss2815update.aspx).

3 Firms for which the PRA is not the global consolidating supervisor are not expected to conduct this assessment or provide the relevant analysis in their ICAAP documents, unless the PRA requests otherwise.

4 PRA Rulebook, ICAAP Part, Rule 13.1 and 14.

5 In this context, 'buffers' refers to capital that local regulatory authorities expect firms to hold in addition to that needed to meet minimum capital requirements, and which is intended to be able to be used in periods of stress.

2.15 When making the above assessment, firms would not be expected to include any minimum requirements and buffers imposed in respect of risks that net off on consolidation, such as intragroup risks or offsetting positions of different group entities.

2.16 Where a firm identifies higher requirements and buffers applied by a local regulatory authority,<sup>1</sup> it should include in its ICAAP submission an explanation of the reason for those higher requirements and buffers.

2.17 Where a firm believes the risk to which an identified higher local regulatory authority capital requirement or buffer applies is already captured in consolidated group capital requirements, it should explain this in its ICAAP submission.

2.18 Firms should also explain in their ICAAP submissions any circumstances in which risks giving rise to higher requirements or buffers in local jurisdictions are mitigated at the consolidation group level by means other than capital resources. For instance, such risks may be mitigated at the group level through risk management processes and internal control mechanisms established at the group level.

2.19 The PRA expects firms to take the difference between any identified higher local regulatory authority minimum requirements and buffers and the minimum requirements and buffers applied by the PRA on a consolidated basis in respect of the same underlying risks into consideration when determining the amount of capital needed to mitigate group risk.<sup>2</sup>

2.20 The PRA proposes to update its Statement of Policy on methodologies for setting Pillar 2 capital (see Appendix 2) to specify that it will take identified higher capital requirements and buffers into account when setting Pillar 2 capital for group risk. Specifically, the PRA proposes :

- when setting Pillar 2A, to take into account the difference between any higher local regulatory authority minimum requirements and the minimum requirements applied on a consolidated basis in respect of the same risks; and
- when setting the PRA Buffer, to take into account the difference between any identified higher local regulatory authority buffers and buffers applied on a consolidated basis in respect of the same risks.

2.21 The PRA's assessment of Pillar 2A and PRA buffer capital for group risk will not reflect local regulatory authority requirements that apply to risks that net off on consolidation or are otherwise captured in capital requirements and buffers set on a consolidated basis.

2.22 Where a firm's ICAAP submission states that a risk giving rise to higher local regulatory requirements or buffers is mitigated at the group level by means other than capital resources, the PRA will consider on a case-by-case basis whether to reflect the risk in the setting of Pillar 2 capital for group risk.

2.23 Under the SMR, firms are required to allocate a Prescribed Responsibility for managing the allocation and maintenance of the firm's capital, funding and liquidity to an individual performing a senior management function (SMF), typically the Chief Finance function (SMF2) or, depending on the organisational structure of a group, a Group Entity Senior Manager

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<sup>1</sup> This includes requirements and buffers applied by local microprudential and macroprudential authorities.

<sup>2</sup> Group risk, as defined in paragraph 1.2 of the ICAA Part of the PRA Rulebook, means the risk that the financial position of a firm may be adversely affected by its relationships (financial or non-financial) with other entities in the same group or by risk which may affect the financial position of the whole group, including reputational contagion.

function (SMF7). In either case, the PRA expects the SMF who is allocated this Prescribed Responsibility to ensure that the analysis of differences in requirements and buffers at different levels of consolidation is provided in the firm's ICAAP submissions and for this to be explicitly reflected in his or her Statement of Responsibilities.

### *Liquidity*

2.24 The liquidity requirements applied by local regulatory authorities may also be different compared to the liquidity requirements for the same risks at the UK consolidation group level. An assessment of the drivers of these differences may be required to ensure an appropriate calibration of the liquidity risks at the UK consolidation group level.

2.25 Liquidity standards are, however, at an earlier stage of implementation internationally than capital standards. The PRA, therefore, proposes to keep under review the assessment and calibration of liquidity risks at different levels of consolidation, especially where it is the global consolidating supervisor of a large international group.

## **3 Location of resources within a group**

3.1 This chapter summarises the PRA's approach to ensuring that firms' resources are appropriately located within a consolidation group, and makes further proposals to address the risks posed by the inappropriate allocation of resources amongst group entities.

### **Importance of the location of financial resources within a group**

3.2 Capital and liquidity resources are not always freely transferable around a group when it matters most. Creditors' and counterparties' claims are on specific legal entities, not groups, and orderly resolution will be facilitated if individual legal entities hold financial resources commensurate with their risks.

3.3 Therefore, resources required on a consolidated basis should be pre-positioned close to risks to ensure entities within the groups are capable of absorbing losses or meeting liabilities as they fall due.<sup>1</sup>

3.4 The necessary degree of alignment between resources and risks varies for capital and liquidity. The allocation of capital should reflect broadly the distribution of risks across legal entities. However, the rapid reversal in market conditions at the onset of the financial crisis illustrated the speed with which liquidity can be withdrawn from certain firms and that illiquidity can last for an extended period of time. An entity's currency risk profile could also be different to that of its wider group. Therefore, the allocation of liquid assets should, in general, be set more precisely relative to risks to ensure effective mitigation than the allocation of capital.

### **Current PRA requirements and supervisory expectations on the location of resources within a group**

3.5 Firms must meet prudential requirements for capital and liquidity on an individual basis. This contributes to the appropriate pre-positioning of resources in the entities undertaking regulated activities. The PRA also requires firms to allocate the total amount of financial

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<sup>1</sup> See footnote 1 on page 7.

resources between different parts of the consolidation group in a way that adequately reflects the nature, level and distribution of the risks to which the consolidation group is subject.<sup>1</sup>

3.6 The PRA requires firms, for the purposes of calculating own funds on an individual basis, to deduct holdings of own fund instruments issued by financial sector entities subject to consolidated supervision.<sup>2</sup> This approach also contributes to ensuring capital is located in the regulated entities where it is needed.

### **Inappropriate allocation of resources amongst group entities**

3.7 In line with the current requirements on the location of resources within a group, the PRA aims to address the risk of entities within groups being under-resourced for the size of the risks they face.

3.8 These under-resourced entities are likely to be unregulated entities. This is because a PRA-regulated entity will be subject to prudential requirements on an individual basis. Similarly, entities authorised and supervised by another regulatory authority will be subject to prudential requirements set by these authorities on an individual or sub-consolidated basis.

3.9 While the PRA does not have a statutory duty to promote the safety and soundness of unregulated entities, experience has shown that their failure or distress could pose risks to authorised firms in the same consolidation group, both through direct losses as well as through reputational and financial contagion effects. Accordingly, assessing the way in which the financial resources, identified as necessary under the overall Pillar 2 rule, are allocated between the entities in a banking group is an important element of the ICAAP process.

### **Proposals**

3.10 To address the risks posed by the inappropriate allocation of resources amongst group entities, the PRA is proposing additional expectations in relation to how firms fulfil their obligations under the ICAA and ILAA Parts of the Rulebook. The PRA is also proposing related changes to how it will assess firms' proposed allocation of resources.<sup>3</sup> The detailed proposals are set out in amendments to SS31/15 (see Appendix 1), the PRA's Statement of Policy 'The PRA's methodologies for setting Pillar 2 capital' (see Appendix 2), and SS24/15 (see Appendix 3).

### **Capital**

3.11 The PRA proposes that firms should provide, in their ICAAP submissions, an analysis of how capital resources are allocated amongst the entities within their consolidation group in relation to the location of the risks they face.<sup>4</sup> The PRA expects this analysis to identify any group entity that contributes more than 5% of the consolidation group's total risk exposure

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1 PRA Rulebook, ICAA Part, Rules 14.8 and 14.9.

2 To do so, the PRA exercises a Competent Authority discretion under Article 49(2) of CRR, and PRA Rulebook, Definition of Capital Part, Rules 2.1, 2.2 and 2.3. The requirement to deduct holdings does not apply to own fund instruments issued by certain investments in venture capital vehicles that are subject to consolidated supervision.

3 This assessment should cover all sources of risk within the group, including risks of financial sector entities that do not have an individual capital or liquidity requirement but which nevertheless contribute to the consolidated risks of the group.

4 Firms for which the PRA is not the global consolidating supervisor are not expected to conduct this assessment or provide the relevant analysis in their ICAAP documents, unless the PRA requests otherwise.



amount and has an individual capital ratio<sup>1</sup> that is lower than the consolidation group's total required capital ratio.<sup>2</sup>

3.12 In relation to these entities, the PRA proposes that firms should explain in their ICAAP submission how this under-allocation is being mitigated, or why it does not represent a risk.

3.13 The PRA will consider taking appropriate actions to ensure a more proportionate allocation of financial resources relative to risks if, after the SREP, it does not consider the firm's proposed allocation to have reflected adequately the nature, level and distribution of the consolidation group's risks. This could include adjusting the amount of firm-specific Pillar 2 capital set for group risk.

3.14 In assessing the firm's proposed allocation of financial resources, the PRA will take into account any analysis the firm provides on the impact of failure of thinly-capitalised entities on the group and any mitigating actions that the firm would take. The PRA will also consider other relevant factors in its assessment, such as a need for the firm to over-allocate financial resources to particular entities on a time-limited basis to accommodate an expected growth in lending or other business expansions.

3.15 The PRA also proposes to make a consequential amendment to ICAA 14.10 (see Appendix 4). The original intention to set up a 'feedback loop' between consolidated requirements and individual requirements in aggregate was not well understood by firms and has been superseded by the proposals in this CP and in related consultations.

### Liquidity

3.16 The PRA considers that a firm's assessment of the liquidity position of its consolidation group<sup>3</sup> should be complemented by information on the location of liquidity in the group. This is to ensure that, at the consolidated level, the PRA is sighted both on where the potential sources of liquidity strain may arise and on where liquid assets are located.<sup>4</sup>

3.17 To this end, firms should include detailed information, at all relevant levels of application of liquidity requirements, in their ILAAPs, on:

- the distribution of outflows, inflows and liquid assets by location, with a breakdown by all significant currencies, as determined under the CRR;<sup>5</sup>
- the distinction between intragroup and external inflows;
- where liquid assets are not aligned to net outflows by currency or by location, a consideration of how liquid assets located elsewhere in the group may be immediately available, with particular emphasis on:
  - the ease with which liquid assets can be moved across legal entities and jurisdictions (including within the same legal entity, for example between a firm's overseas branch and a firm's head office);

1 Defined as own funds divided by total risk-weighted assets (RWAs).

2 Defined as the consolidated Individual Capital Guidance (ICG) divided by total group RWAs. The PRA is currently consulting on replacing the term 'Individual Capital Guidance (ICG)' with the term 'Total Capital Requirement (TCR)'. See CP12/17 'Pillar 2A capital requirements and disclosure', July 2017: [www.bankofengland.co.uk/pr/Pages/publications/cp/2017/cp1217.aspx](http://www.bankofengland.co.uk/pr/Pages/publications/cp/2017/cp1217.aspx).

3 PRA Rulebook, ILAA Part, Rule 2 and Rule 14.

4 PRA Rulebook, ILAA Part, Rule 8.

5 CRR Article 415(2) requires firms to report on a single currency basis, any currency which exceeds 5% of aggregate liabilities.

- the ease with which liquid assets can be moved across different time zones;
  - the ease with which liquid assets can be transferred from one currency into another (including the operational ease of monetisation);
  - the potential consequences of moving liquid assets across different legal entities and jurisdictions; and
  - the entities, decision-making bodies and processes involved in the control of the movement of these liquid assets and the potential impact on the immediate availability of those liquid assets; and
- where outflows at an individual (or sub-group) level are significantly covered by intragroup inflows, a consideration of the impact of stress on intragroup inflows.

3.18 For the avoidance of doubt, the PRA expects all firms to conduct this assessment or provide the relevant analysis in their ILAAP documents, including those for which the PRA is not the global consolidating supervisor.

3.19 As set out in CP13/17,<sup>1</sup> the PRA proposes to address intragroup liquidity risk on a case-by-case basis, taking into consideration the degree of intragroup interconnectedness. This includes group entities' degree of willingness and ability to support one another in both business-as-usual and stress situations.

3.20 Under the SMR, firms are required to allocate a Prescribed Responsibility for managing the allocation and maintenance of the firm's capital, funding and liquidity to an individual performing a senior management function (SMF), typically the Chief Finance function (SMF2) or, depending on the organisational structure of a group, a Group Entity Senior Manager function (SMF7). In either case, the PRA expects the SMF who is allocated this Prescribed Responsibility to ensure that this assessment is provided in the firm's ICAAP and ILAAP submission and for this to be explicitly reflected in his or her Statement of Responsibilities.

## 4 Other proposals under consultation to refine the groups policy framework

4.1 A firm's relationships with other entities in the group may affect its prudential soundness, for example through access to capital, intra-group exposures or contagion. The PRA is consulting on a number of policy proposals that refine this aspect of the PRA's framework for groups policy. They are summarised in this chapter.

### Setting Pillar 2A capital requirement on an individual basis

4.2 When setting Pillar 2A capital requirements on an individual basis, the default approach is to undertake a full assessment on the individual basis, calculating the relevant Pillar 2 risks according to the individual entity's risk profile. Where firms are part of a UK consolidation group, or part of an RFB sub-group, the PRA is currently consulting on proposals to take a proportionate approach, as explained below, to calibrating the Pillar 2A add-on on an

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1 See PRA Consultation Paper 13/17 'Pillar 2 Liquidity', July 2017: [www.bankofengland.co.uk/pr/Pages/publications/cp/2017/cp1317.aspx](http://www.bankofengland.co.uk/pr/Pages/publications/cp/2017/cp1317.aspx).

individual basis.<sup>1</sup> The proposals should provide additional clarity on when and how Pillar 2A capital requirement may be set by the PRA at the individual level.

4.3 Where the firm is part of a UK consolidation group or RFB sub-group and it can demonstrate certain characteristics between the group entities,<sup>2</sup> the PRA may set an individual Pillar 2A requirement calibrated to represent an appropriate share of the UK consolidated Individual Capital Guidance (ICG) (or RFB sub-consolidated ICG) in recognition of the alignment of business models.

4.4 Where a firm is not considered to have significant systemic impact or where it has a very similar risk profile to its consolidation group or RFB sub-group, the PRA may decide to set a Pillar 2A requirement on an individual basis by reference to the UK consolidated (or RFB sub-consolidated) Pillar 2A calculation. This would be set by applying the same Pillar 2A add-on rate as calculated for the UK consolidated (or for RFBs, RFB sub-consolidated) Pillar 2A capital requirement to the individual total risk-weighted assets (RWA) of the firm, unless an alternative allocation of Pillar 2A component risk elements is agreed by the PRA.

### Large exposures

4.5 The LE framework complements the risk-based capital standard, specifically to protect firms from large losses resulting from a sudden default of a single counterparty or a group of connected counterparties. Within its own consolidation group, a firm is required to treat its exposures to other group entities as if they were exposures to a third party.<sup>3</sup>

4.6 However, where group entities are strongly incentivised to support each other and certain other conditions are met such as demonstration of transferability of resources between those group entities, the PRA will consider granting a core UK group (CUG) or a non-core large exposures group (NCLEG) permission to a firm that exempt certain intragroup exposures from the LE limit.<sup>4</sup>

4.7 In CP 20/17,<sup>5</sup> the PRA is proposing:

- Enhanced guidance on the application of criteria for CUG and NCLEG permissions.
- Changing the NCLEG calibration basis for firms that have both a CUG and an NCLEG permission.
- Changing how the NCLEG permission applies at the UK consolidated group level.

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1 PRA Consultation Paper 12/17 'Pillar 2A capital requirements and disclosure', July 2017: [www.bankofengland.co.uk/pr/Pages/publications/cp/2017/cp1217.aspx](http://www.bankofengland.co.uk/pr/Pages/publications/cp/2017/cp1217.aspx).

2 These include, but not limited to: i) an adequate allocation of capital between subsidiaries; ii) the members of the UK consolidation group or RFB sub-group are strongly incentivised to support each other; and iii) no impediments to the transfer of financial resources between members of the UK consolidation group or RFB sub-group.

3 As specified in Article 395(1) of CRR, a firm's intragroup exposures are limited to 25% of its eligible capital.

4 The PRA will consider granting a core UK group (CUG) permission to a firm for its exposures to other group entities established in the UK to be subject to 0% risk weight, provided these entities meet certain conditions. On application of the 0% risk weight, these exposures are exempt from the firm's individual LE limit. The PRA will also consider granting NCLEG permissions to a firm for its trading book and non-trading book exposures to group entities that meet specified conditions. A firm's total exposure to members of its NCLEG is limited to 100% of the firm's eligible capital. Further details of how the PRA will exercise this discretion is provided in PRA Supervisory Statement 16/13 'Large Exposures': [www.bankofengland.co.uk/pr/Pages/publications/largeexpos.aspx](http://www.bankofengland.co.uk/pr/Pages/publications/largeexpos.aspx).

5 PRA Consultation Paper 20/17 'Changes to the PRA's large exposures framework', October 2017: <http://www.bankofengland.co.uk/pr/Pages/publications/cp/2017/cp2017.aspx>

4.8 The Bank of England is currently consulting on a policy framework for setting internal minimum requirement for own funds and eligible liabilities (MREL).<sup>1</sup> The Bank's proposed approach to internal MREL requires material operating entities to issue internal MREL resources to the parent entity or to its resolution entity within the group.

4.9 Intragroup exposures created due to internal MREL may be subject to LE limits. As internal MREL does not carry the risk that the LE framework is designed to mitigate, the PRA is proposing, in CP20/17, that firms can apply to exempt internal MREL exposures from the LE limits.

### **Intragroup liquidity risk**

4.10 As a lending entity, some of a firm's claims on other group entities may give rise to 100% inflows under the Liquidity Coverage Requirement (LCR) rules. These claims could be deposits placed with other group entities or intragroup lending transactions maturing within 30 days, either unsecured or secured by assets that do not qualify as liquid assets.<sup>2</sup> While this recognises that entities within the same group are strongly interconnected and reliant on each other, there is a risk that these inflows may not materialise in a stress situation, as the borrowing entity may be more likely to push for rollover of its funding with the lending entity as both belong to the same group.

4.11 Intragroup liquidity risk can also arise when liquidity is unable to flow freely within one group, because of legal, contractual, regulatory or operational limitations resulting in liquidity being trapped in business as usual circumstances or becoming trapped under stress.

4.12 As set out in CP13/17, the PRA proposes to address intragroup liquidity risk on a case-by-case basis, taking into consideration the degree of intragroup interconnectedness. This includes group entities' degree of willingness and ability to support one another in both business-as-usual and stress situations.

## **5 The PRA's statutory obligations**

5.1 Before making any rules, the Financial Services and Markets Act 2000 (FSMA)<sup>3</sup> requires the PRA to publish a draft of the proposed rules accompanied by:

- a cost benefit analysis;
- an explanation of the PRA's reasons for believing that making the proposed rules is compatible with the PRA's duty to act in a way that advances its general objective,<sup>4</sup> insurance objective<sup>5</sup> (if applicable), and secondary competition objective;<sup>6</sup>
- an explanation of the PRA's reasons for believing that making the proposed rules are compatible with its duty to have regard to the regulatory principles;<sup>7</sup> and

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1 'Internal MREL - the Bank of England's approach to setting a minimum requirement for own funds and eligible liabilities (MREL) within groups and further issues', Consultation on a proposed updated Statement of Policy, October 2017: <http://www.bankofengland.co.uk/financialstability/Documents/resolution/mrelconsultation2017.pdf>

2 EU LCR Delegated Act, Article 32.

3 Section 138J of FSMA.

4 Section 2B of FSMA.

5 Section 2C of FSMA.

6 Section 2H(1) of FSMA.

7 Sections 2H(2) and 3B of FSMA.

- a statement as to whether the impact of the proposed rules will be significantly different to mutuals than to other persons.<sup>1</sup>

5.2 The PRA is required by the Equality Act 2010<sup>2</sup> to have due regard to the need to eliminate discrimination and to promote equality of opportunity in carrying out its policies, services and functions.

5.3 The PRA should also have regard to aspects of the economic policy of Her Majesty's government as recommended in HM Treasury's recommendations letter.<sup>3</sup>

### Cost benefit analysis

5.4 The proposals contained in this CP fall into two areas: (i) assessment and reporting requirements under the ICAAP/SREP and ILAAP/L-SREP frameworks; and (ii) requirements to mitigate risks to group resilience that may result in higher capital resources at consolidated group level. Regarding the latter, banking groups may need more capital where it was concluded:

- that there exists payment and maturity mismatch risks that are not adequately managed or mitigated (Chapter 2);
- there exist differences between consolidated requirements and requirements imposed by local regulatory authorities (Chapter 2); or
- any material group entity is not adequately capitalised nor can credibly rely on support from other group entities (Chapter 3).

5.5 The cost benefit analysis below considers the impact from these proposals that are envisaged to commence in full from 2019.

### Assessment and reporting requirements

5.6 Banking groups are already required, as part of their ICAAP and ILAAP, to conduct internal stress tests and scenario analysis to ensure the resilience of the group, in terms of both capital and liquidity adequacy, taking into consideration the existence of mitigating factors and credible management actions. Similarly, banking groups are already required to make sure that capital is appropriately distributed across the group. Where applicable, firms must comply with the requirement to actively manage their liquidity risk exposures and related funding needs and take into account existing legal, regulatory and operational limitations to potential transfers of liquidity and unencumbered assets amongst entities and any other constraints on the transferability of liquidity and unencumbered assets across business lines, countries and currencies on the basis of the relevant consolidated situation.

5.7 The proposals contained in this CP formalise and expand on these existing requirements by, in particular, asking banking groups to explicitly monitor and report on whether there are payment and maturity mismatch risks due to the use of double leverage, and the extent to which these risks are properly managed and mitigated. These proposals will therefore ensure a consistent application of those existing requirements and will allow firms to understand how the PRA has formed its expectations regarding the use of double leverage. This increased transparency is a benefit of these proposals.

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1 Section 138K of FSMA.

2 Section 149.

3 [www.gov.uk/government/publications/recommendations-for-the-prudential-regulation-committee-spring-budget-2017](http://www.gov.uk/government/publications/recommendations-for-the-prudential-regulation-committee-spring-budget-2017).

5.8 The PRA believes that these enhanced requirements would not result in material additional costs for firms to the extent that banking groups will largely be able to rely on existing analysis and information. This is particularly so given the low frequency of reporting under the existing ICAAP and ILAAP timeframe.

#### Potential requirements to increase capital resources at group level

5.9 Where, as a result of the SREP, a view is reached that there are excessive levels of double leverage that give rise to payment and maturity mismatch risks that are not adequately managed and mitigated, the PRA would set firm-specific limits to the permissible use of double leverage. This may have an impact on firms' capital planning assumptions. However, the PRA believes that the benefit of reducing the threat to the safety and soundness of PRA-authorised entities in the group as a result of payment and maturity mismatch risks being mitigated would offset any additional costs to firms due to a change in their capital planning assumptions.

5.10 Banking groups could be expected to adjust their capital resources where an overseas subsidiary is subject to individual (or sub-consolidated) prudential requirements set by the local regulatory authority which are higher than the corresponding requirements at consolidated level or where individual (or sub-consolidated) requirements capitalise a risk that does not net out in consolidation. In practice, this is expected to apply to a very small number of internationally active banking groups. The aggregate capital added as a percentage of group RWA for the firms expected to be impacted would be 0.09% on average. Assuming a 10% equity premium, this increase in capital requirement would push up firms' overall funding costs by around 0.4 basis points. The extent to which firms are able to pass this on to consumers will depend on the level of competition and substitution in the markets concerned. Nevertheless, in light of the small magnitude of the estimated increase in the cost of funding the PRA believes that the overall cost would not be significant and it would be offset by the benefits resulting from a more rigorous capitalisation of risks amongst group entities.

5.11 In addition, the PRA will take appropriate actions to ensure a proportionate allocation of capital resources within the group if, after the SREP, it is revealed that a material group entity is not adequately capitalised nor can credibly rely on support from other group entities. This may also have an impact on firms' capital planning assumptions. Failure of an undercapitalised material group entity may threaten the safety and soundness of PRA authorised firms due to contagion risks. The PRA believes that the benefits of mitigating this group risk would offset any additional costs to firms due to a change in their capital planning assumptions.

#### Compatibility with the PRA's objectives

5.12 The PRA has a statutory objective to promote the safety and soundness of banks, building societies, credit unions, insurers and PRA-designated investment firms. The proposals in this CP are intended to further that objective by ensuring that the PRA has an appropriate framework to ensure that risks associated with double leverage are managed appropriately, and to improve the PRA's supervision of the manner in which firms allocate capital and liquidity resources within their groups.

5.13 Double leverage can introduce payment and maturity mismatch risks for holding companies to the extent that they rely on dividend income from their subsidiaries to service and redeem the debt they have raised. If not properly managed these risks can threaten the safety and soundness of PRA authorised subsidiaries due to both direct credit losses and adverse reputational contagion if their holding companies become distressed.

5.14 Therefore, where appropriate, the proposed framework will also enable the PRA to mitigate payment and maturity mismatch risks for holding companies in ways other than

requiring firms to hold liquid assets, for example by limiting the amount of double leverage to prevent the level becoming excessive. Specifically, this action could be taken where a risk giving rise to higher local regulatory requirements or buffers is mitigated at the group level by means other than capital resources. In both cases, these actions contribute to the PRA's objective of promoting the safety and soundness of firms.

5.15 When discharging its general function in a way that advances its primary objectives, the PRA has, as a secondary objective, a duty to facilitate effective competition in the markets for services provided by PRA-authorized persons. These proposals enhance effective competition by ensuring that banking groups' use of double leverage is assessed and properly managed, thereby preventing unregulated entities within these groups that are under-resourced for the risks they face, and the groups that contain these under-resourced unregulated entities, from gaining an undue competitive advantage thanks to the resulting lower cost of funding.

### Regulatory principles

5.16 In developing the proposals in this CP, the PRA has had regard to the regulatory principles. Three of the principles are of particular relevance:

- *The principle that a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction.* The proposals in this CP seek to preserve the effectiveness of existing capital adequacy rules for regulated subsidiaries in banking groups without ruling out the use of double leverage for those intragroup risks and offsetting positions which net out on a consolidated basis, or where higher requirements for an overseas subsidiary reflect a difference of approach between the PRA (as lead authority) and a local regulatory authority. Furthermore, whilst the proposals contained in this CP are primarily aimed at banking groups for which the PRA is the lead consolidating supervisor, the impact on medium and small sized domestic groups is not expected to be material.
- *The principle that the PRA should exercise its functions as transparently as possible.* In this CP, the PRA sets out the key information relevant to its proposals, and gives respondents the opportunity to comment. Furthermore, the PRA judges that the proposals outlined in this CP bring greater clarity on compliance with existing PRA requirements regarding capital allocation across banking groups.
- *The desirability in appropriate cases of the PRA exercising its functions in a way that recognises differences in the nature of, and objectives of, business carried on by different persons subject to requirements imposed by or under the Act.* Although the proposals in this CP will affect only a relatively small number of banking groups, the PRA recognises that even within this population there will be a range of business models. The PRA has taken this into consideration when developing its proposals, for example in relation to recognition that there may be temporary over-allocation of capital to a particular entity to accommodate an expected growth in lending or other business expansions.

### HM Treasury recommendation letter

5.17 HM Treasury has made recommendations to the Prudential Regulation Committee about aspects of the Government's economic policy to which the Committee should have regard

when considering how to advance the objectives of the PRA and apply the regulatory principles as set out in FSMA.<sup>1</sup>

5.18 The aspects of the Government's economic policy most relevant to the proposals in this CP are:

### Competitiveness

5.19 The Government wishes to ensure that the United Kingdom remains an attractive domicile for internationally active financial institutions, and that London retains its position as the leading international financial centre. The Government considers that achieving this aim in a manner that is consistent with robust institutions and a resilient system will support its aims for sustainable economic growth.

5.20 The PRA believes that these proposals are consistent with robust institutions and a resilient system, and will not materially affect London's position as a leading international financial centre. This is because the proposals aim at maintaining or enhancing the quality of supervision applied to the banking groups in scope.

### Innovation

5.21 The Government is keen to see innovation in the financial services sector and how this can support the wider economy, through new methods of engaging with consumers of financial services and new ways of raising capital. This includes recognising differences in the nature and objectives of business models and ensuring burdens are proportionate.

5.22 The PRA considers that the proposals contained in this CP do not put at risk this economic policy aim. The proposed methodologies will be applied with supervisory discretion, taking into account business models and the materiality of risks due to excessive double leverage.

### Better outcome for consumers

5.23 The Government wants to see financial services work in the best interests of consumers and businesses they serve. This is supported by improved competition in financial services and the securing of an appropriate degree of protection for consumers.

5.24 The PRA considers that the proposals contained in this CP are consistent with this economic policy aim, to the extent that it prevents regulated entities within banking groups from being exposed to the risk of both direct credit losses and adverse reputational contagion.

### Impact on mutuals

5.25 The proposals in this CP do not apply to mutuals (in this case building societies) as they do not have parent holding companies. The higher of individual or consolidated requirements will bind on mutuals as currently.

### Equality and diversity

5.26 The PRA has performed an assessment of the policy proposals and does not consider that the proposals give rise to equality and diversity implications.

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<sup>1</sup> [www.gov.uk/government/publications/recommendations-for-the-prudential-regulation-committee-spring-budget-2017](http://www.gov.uk/government/publications/recommendations-for-the-prudential-regulation-committee-spring-budget-2017).



## Appendices

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- 1**      **Draft amendments to Supervisory Statement 31/15 ‘The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)’**

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  - 2**      **Draft amendments to Statement of Policy ‘The PRA’s methodologies for setting Pillar 2 capital’**

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  - 3**      **Draft amendments to Supervisory Statement 24/15 ‘The PRA’s approach to supervising funding and liquidity risks’**

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  - 4**      **Draft instrument**

## Appendix 1: Draft amendments to Supervisory Statement 31/15 ‘The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)’

This appendix outlines proposed amendments to Supervisory Statement 31/15. Underlining indicates new text and striking through indicates deleted text.

The PRA is consulting, in Consultation Paper 12/17, on additional amendments to the text currently under consultation in this CP.

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### Group risk

2.16 Under the PRA Rulebook a firm is required to have adequate, sound and appropriate risk management processes and internal control mechanisms for the purpose of assessing and managing its own exposure to group risk, including sound administrative and accounting procedures.<sup>1</sup>

2.16A Group risk, as defined in the PRA Rulebook,<sup>2</sup> means the risk that the financial position of a firm may be adversely affected by its relationships (financial or non-financial) with other entities in the same group or by risk which may affect the financial position of the whole group, including reputational contagion.

2.16AA Where a firm is a member of a consolidation group, it should provide in its ICAAP document sufficient information to demonstrate how it is meeting the requirements under ICAA 14.8 and 14.9 to allocate the total amount of financial resources, own funds and internal capital between different parts of the consolidation group in a way that adequately reflects the nature, level and distribution of the risks to which the consolidation group is subject. This assessment should cover all sources of risk within the group, including risks of financial sector entities that do not have an individual capital requirement but which nevertheless contribute to the consolidated risks of the group. Firms for which the PRA is not the global consolidating supervisor are not expected to conduct this assessment or provide the relevant analysis in their ICAAP documents, unless the PRA requests otherwise.

2.16AB Specifically, where a financial sector entity’s<sup>3</sup> contribution to the consolidation group’s RWAs exceeds 5% and its capital ratio (defined as own funds divided by total RWAs) is lower than the consolidation group’s total capital requirement, the firm is expected to:

- identify in its ICAAP document any mitigating actions it is taking to manage this under-allocation;<sup>4</sup> or
- demonstrate that there is no group risk from the under-allocation of capital to this entity (eg because there is no current or foreseen material practical or legal impediment to the prompt transfer of resources to that entity; the shortfall is temporary; or the safety and

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1 Group Risk Systems 2.1.

2 Internal Capital Adequacy Assessment 1.2.

3 As defined in Article 4(1) of CRR.

4 Mitigating actions might include, for example, the reallocation of resources from other entities within the group or the raising of additional capital resources.

soundness of the entity is not material to the financial position of the firm or the consolidation group of which it is a member).

2.16AC Where a firm is a member of a consolidation group, and the group includes an entity established outside the United Kingdom, the PRA expects the firm, when it is assessing group risk, to consider any capital requirements or buffers applied to the entity<sup>1</sup> established outside the United Kingdom. Specifically, the PRA expects a firm to consider the extent to which:

- for any given risk type, the minimum requirements applied to the entity exceed the entity's share of the consolidated group requirements for the same underlying risk; and
- any buffers applied to the entity exceed the entity's share of the consolidated group buffer applied for the same underlying risk.<sup>2</sup>

2.16AD An entity's share of a particular consolidated group capital requirement or buffer can be determined by multiplying that consolidated group capital requirement or buffer by the proportion of the consolidated group's Pillar 1 RWAs that are attributable to that entity. The consolidated group's RWAs that are attributable to an entity is calculated as the entity's Pillar 1 RWAs, calculated on the same basis as the group RWAs, minus the risk-weighted exposures of the entity to other group entities.

2.16AE Firms for which the PRA is not the global consolidating supervisor are not expected to conduct this assessment or provide the relevant analysis in their ICAAP documents, unless the PRA requests otherwise.

2.16AF The PRA does not expect firms to include in this assessment requirements imposed on entities established outside the United Kingdom that are attributable to risks that:

- are already mitigated through the risk based capital framework (including requirements that are higher than the equivalent requirement applied on a consolidated basis because of a difference of approach between the PRA and the regulatory authority in the jurisdiction concerned)<sup>3</sup> or by other means;<sup>4</sup> or
- net off in consolidation (for example, intragroup risks and offsetting positions).

2.16AG Under ICAA 13.1, a firm must make a written record of the assessments required under the ICAA part of the PRA Rulebook. A firm's record of its approach to making the assessment in paragraph 2.16AC should cover the following, as appropriate:

- for any given risk type, the minimum requirements or buffers applied to an entity established outside the United Kingdom that exceed the entity's share of the consolidated group requirements for the same risk or buffer;

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<sup>1</sup> Whether on an individual, sub-consolidated or country-level consolidated basis.

<sup>2</sup> For example, the extent to which any domestic systemically important bank (D-SIB) buffer exceeds the D-SIB's share of any group-wide global systemically important bank (G-SIB) buffer, after accounting for the effect of risks that net off on consolidation.

<sup>3</sup> For example, a PRA authorised firm may have permission to use an IRB model to calculate consolidated capital requirements in respect of a portfolio of credit risk exposures. If its overseas subsidiary is required to use a standardised approach for the same portfolio of credit risk exposures (on an individual or sub-consolidated basis), and as a result it is subject to higher requirements in respect of that portfolio, the PRA would not expect the firm to take the difference into account in its assessment of group risk.

<sup>4</sup> For example, the risk of a local entity might be mitigated at the group level through risk management processes or internal control mechanisms established at the group level.

- any such differences that the firm considers are already mitigated through the risk-based capital framework or by another means; and
- how any additional capital to cover group risk has been calculated.

2.16AH Under the Senior Managers Regime,<sup>1</sup> firms are required to allocate a Prescribed Responsibility for managing the allocation and maintenance of the firm’s capital, funding and liquidity to an individual performing a senior management function (SMF).<sup>2</sup> The PRA expects:

- the SMF who is allocated this Prescribed Responsibility to ensure that the firm conducts the assessments specified in paragraphs 2.16AA to 2.16AG, and documents them in the firm’s ICAAP submissions; and
- firms to ensure this expectation is explicitly reflected in the relevant SMF’s Statement of Responsibilities.

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### **3 Stress testing, scenario analysis and capital planning**

....

#### **Double leverage**

3.29 Where a firm is a member of a group in which a qualifying parent undertaking<sup>3</sup> has a double leverage ratio above 100%, or is projecting a double leverage ratio above 100%, the PRA expects the firm to assess and mitigate the risks of double leverage, including the cash-flow risks incurred by its qualifying parent undertaking, as part of its stress testing and scenario analysis. For this purpose, double leverage ratio is defined as a qualifying parent undertaking’s Common Equity Tier 1 (CET1) capital investment in its subsidiaries<sup>4</sup> divided by its own CET1 capital.

3.30 These expectations also apply where the firm is a member of a group which uses a different definition of double leverage, or calculates double leverage in respect of a grouping of companies,<sup>5</sup> and its double leverage ratio is over 100% or is projected to be over 100%. In these circumstances, information should be provided in respect of the qualifying parent undertaking’s double leverage ratio as set out above, as well as in respect of the firm’s own methodology.

3.31 Specifically, in its ICAAP document the PRA expects the firm to:

- provide details of the qualifying parent undertaking’s double leverage ratio and the projected double leverage ratio on a forward-looking basis over a three- to five-year time horizon;

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<sup>1</sup> See Rule 4.1(7) in the Allocation of Responsibilities part of the PRA Rulebook and Supervisory Statement 28/15 ‘Strengthening individual accountability in banking’, May 2017.

<sup>2</sup> Typically the Chief Finance function (SMF2) or, depending on the organisational structure of a group, a Group Entity Senior Manager (SMF7).

<sup>3</sup> Section 192B FSMA.

<sup>4</sup> As defined in Article 4(1) of CRR.

<sup>5</sup> For example the ultimate qualifying parent undertaking and a number of intermediate parent undertakings.

- explain how the risks of double leverage are assessed and managed, including any mitigating factors in place (e.g. any unencumbered liquid assets held by the qualifying parent undertaking to cover the risk of a shortfall in income to meet its interest obligations);
- develop and analyse relevant stress or recovery scenarios, including where the qualifying parent undertaking's inflows from its subsidiaries are significantly reduced and/or market conditions make it difficult to rollover existing debt. Specifically, it should consider any constraints that have been or might be imposed on dividend payments from an entity established outside the United Kingdom to its qualifying parent undertaking;
- provide information on the qualifying parent undertaking's expected quarterly inflows and outflows under both normal and stressed conditions over a three- to five-year time horizon; and
- identify what management actions the firm would take in a stress to manage the risks of double leverage and the impact those management actions would have on the qualifying parent undertaking's inflows and outflows and on its double leverage ratio.

3.32 Firms for which the PRA is not the global consolidating supervisor are not expected to conduct this assessment or provide the relevant analysis in their ICAAP documents, unless the PRA requests otherwise.

3.33 Under the Senior Managers Regime,<sup>1</sup> firms are required to allocate a Prescribed Responsibility for managing the allocation and maintenance of the firm's capital, funding and liquidity to an individual performing a senior management function (SMF).<sup>2</sup> The PRA expects

- the SMF who is allocated this Prescribed Responsibility to ensure that the firm conducts the assessments specified in paragraphs 3.29 to 3.31 and documents them in the firm's ICAAP submissions; and
- firms to ensure this expectation is explicitly reflected in the relevant SMF's Statement of Responsibilities.

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## **5 The SREP**

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5.5 The SREP will also consider:

- the results of stress tests carried out in accordance with the CRR by firms that use an internal ratings-based (IRB) approach or internal models for market risk capital requirements;

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<sup>1</sup> See Rule 4.1(7) in the Allocation of Responsibilities part of the PRA Rulebook and PRA Supervisory Statement 28/15 'Strengthening individual accountability in banking', May 2017.

<sup>2</sup> Typically the Chief Finance function (SMF2) or, depending on the organisational structure of a group, a Group Entity Senior Manager (SMF7).

- the exposure to, and management of, concentration risk by firms, including their compliance with the requirements set out in Part Four of the CRR and Chapter 6 of the ICAA rules;
- the robustness, suitability and manner of application of policies and procedures implemented by firms for the management of the residual risk associated with the use of credit risk mitigation techniques;
- the extent to which the capital held by firms in respect of assets which it has securitised is adequate, having regard to the economic substance of the transaction, including the degree of risk transfer achieved;
- the exposure and management of liquidity risk by firms, including the development of alternative scenario analyses, the management of risk mitigants (including the level, composition and quality of liquidity buffers), and effective contingency plans;
- the impact of diversification effects and how such effects are factored into firms' risk measurement system;
- the geographical location of firms' exposures;
- risks to firms arising from excessive leverage;
- whether a firm has provided implicit support to a securitisation; ~~and~~
- the exposure to and management of foreign currency lending risk to unhedged retail and SME borrowers by firms, in line with Title 6, section 2 paragraphs 158–59 of the EBA's Guidelines on common procedures and methodologies for the SREP-;
- the extent to which the allocation of the total amount of financial resources, own funds and internal capital between different parts of the consolidation group reflects the nature, level and distribution of the risks to which the consolidation group is subject;
- the extent to which any capital requirements or buffers set on an entity established outside the United Kingdom, on an individual or sub-consolidated basis, exceed the requirements or buffers applicable at the consolidated group level to cover the same risk;  
and
- where a firm is a member of a group in which a qualifying parent undertaking has a double leverage ratio above 100%, or is projecting a double leverage ratio above 100%, the extent to which the firm is managing the risks of double leverage, and the credibility of its related stress testing and scenario analysis.

## Appendix 2: Draft amendments to Statement of Policy ‘The PRA’s methodologies for setting Pillar 2 capital’

This appendix outlines proposed amendments to Statement of Policy ‘The PRA’s methodologies for setting Pillar 2 capital’. Underlining indicates new text and striking through indicates deleted text.

The PRA is consulting, in Consultation Paper 12/17, on additional amendments to the text currently under consultation in this CP.

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### Contents

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8A ~~Pillar 2A for~~ Group Risk, including RFB group risk

...

#### 1 Introduction

...

1.2 Section I: Pillar 2A methodologies sets out the methodologies the PRA will use to inform the setting of a firm’s Pillar 2A capital requirement for credit risk, market risk, operational risk, counterparty credit risk, credit concentration risk, interest rate risk in the non-trading book (hereafter referred to as interest rate risk in the banking book (IRRBB)), pension obligation risk and group risk, including RFB group risk.

1.3 Section II: Pillar 2B provides information on the purpose of the PRA buffer, how it is determined and how it relates to the CRD IV buffers. Section II also provides details on the PRA’s approach to tackling weak governance and risk management under Pillar 2B and group risk, including RFB group risk.

...

### Section I: Pillar 2A methodologies

...

#### 8A Group risk, including ~~Pillar 2A for~~ RFB group risk

8A.1 This chapter sets out the methodology the PRA uses to inform the setting of a firm’s Pillar 2A capital requirement for group risk, including RFB group risk, where groups contain an RFB sub-group.

## Definition and scope of application

8A.2 Group risk, as defined in the PRA Rulebook,<sup>1</sup> means the risk that the financial position of a firm may be adversely affected by its relationships (financial or non-financial) with other entities in the same group or by risk which may affect the financial position of the whole group, including reputational contagion.

## Methodology

8A.2A The PRA's assessment of group risk will be informed by the following:

- the extent to which the allocation of the total amount of financial resources, own funds and internal capital between different parts of the consolidation group adequately reflects the nature, level and distribution of the risks to which the consolidation group is subject;
- the extent to which, for any given risk type, the minimum requirements applied to an entity established outside the United Kingdom, on an individual or sub-consolidated basis, exceed the entity's share<sup>2</sup> of the consolidated group requirements for the same risk. When making this assessment, the PRA would not generally take into account requirements that are attributable to risks that:
  - (i) are already mitigated through the risk based capital framework<sup>3</sup> or by other means;<sup>4</sup> or
  - (ii) net off in consolidation (for example, intragroup risks and offsetting positions); and
- where a firm is a member of a group in which a qualifying parent undertaking<sup>5</sup> has a double leverage ratio above 100%, or is projecting a double leverage ratio above 100%, the firm's approach to managing the risks of double leverage, including the cash flow risks, and the credibility of its related stress testing and scenario analysis. For this purpose, double leverage ratio is defined as a parent company's Common Equity Tier 1 (CET1) capital investment in its subsidiaries<sup>6</sup> divided by its own CET1 capital.

8A.2B Supervisory judgement is used to determine:

- the amount of firm-specific Pillar 2A capital requirements for group risk; and
- any steps that need to be taken in respect of any double leverage being used or proposing to be used by a firm's qualifying parent undertaking. Such steps may include, for example,

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<sup>1</sup> Internal Capital Adequacy Assessment 1.2.

<sup>2</sup> An entity's share of a particular consolidated group capital requirement can be determined by multiplying that consolidated group capital requirement by the proportion of the consolidated group's Pillar 1 RWAs that are attributable to that entity. The consolidated group's RWAs that are attributable to an entity is calculated as the entity's Pillar 1 RWAs, calculated on the same basis as the group RWAs, minus the risk-weighted exposures of the entity to other group entities.

<sup>3</sup> For example, a PRA authorised firm may have permission to use an IRB model to calculate consolidated capital requirements in respect of a portfolio of credit risk exposures. If its overseas subsidiary is required to use a standardised approach for the same portfolio of credit risk exposures (on an individual or sub-consolidated basis), and as a result, it is subject to higher requirements in respect of that portfolio, the PRA would not take the difference into account in its assessment of group risk.

<sup>4</sup> For example, the risk of a local entity might be mitigated at the group level through risk management processes or internal control mechanisms established at the group level.

<sup>5</sup> Section 192B FSMA

<sup>6</sup> As defined in Article 4(1) of CRR.



imposing a specific limit on the amount of double leverage a firm's qualifying parent undertaking can use.<sup>1</sup>

### **RFB group risk**

## **Section II: Pillar 2B**

### **9 The PRA buffer**

9.5A Where a particular buffer<sup>2</sup> for an entity established outside the United Kingdom exceeds that entity's share<sup>3</sup> of the buffer applicable at the consolidated group level to cover the same risk, the difference will generally be reflected in the setting of the consolidated group's PRA buffer to reflect the associated group risk at the consolidated group level. The PRA would generally not reflect such a difference in the consolidated group PRA buffer where the underlying risk of the credit institution established outside the United Kingdom is otherwise mitigated in the consolidated group requirements.

9.5AB Where a particular buffer applicable on a sub-consolidated basis for the RFB sub-group is higher than the RFB sub-group's share<sup>4</sup> of the corresponding buffer on a consolidated basis, the difference will generally be reflected in the setting of the consolidated group's PRA buffer to reflect the associated RFB group risk at the consolidated group level.

9.5BC Where the PRA sets additional capital in the consolidated PRA buffer to cover group risk or RFB group risk, it should not be reduced as the CRD IV buffers phase in, for the purposes of that part of the PRA buffer assessment.

### **Other factors affecting the PRA buffer assessment**

### **Pillar 2B for group risk**

9.33A The PRA's assessment of the total amount of the PRA buffer at consolidated group level for group risk will be informed by the amount by which any buffer applicable on an entity

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1 For example, by exercising the PRA's power of direction under Section 192C of the Financial Services and Markets Act (Power of Direction over Qualifying Parent Undertakings).

2 In this context, buffer refers to capital that overseas authorities expect firms to hold in addition to minimum capital, and which is intended to be able to be drawn down in periods of stress.

3 An entity's share of a particular consolidated group buffer can be determined by multiplying that consolidated group buffer by the proportion of the consolidated group's Pillar 1 RWAs that are attributable to that entity. The consolidated group's RWAs that are attributable to an entity is calculated as the entity's Pillar 1 RWAs, calculated on the same basis as the group RWAs, minus the risk-weighted exposures of that entity to other group entities.

4 The RFB sub-group's share of a particular consolidated group buffer can be determined by multiplying that consolidated group buffer by the proportion of the consolidated group's Pillar 1 RWAs that are attributable to the RFB sub-group. The consolidated group's RWAs that are attributable to the RFB sub-group is calculated as the RFB sub-group's Pillar 1 RWAs (calculated on a sub-consolidated basis) minus the risk-weighted exposures of the RFB sub-group to group entities that are not members of the RFB sub-group.

established outside the United Kingdom exceeds that entity's share of the buffer applicable at the consolidated group level to cover the same risk.<sup>1,2</sup>

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1 For example, when making this assessment, the PRA may consider the extent to which any domestic systemically important bank (D-SIB) buffer exceeds the D-SIB's share of any group-wide global systemically important bank (G-SIB) buffer, after accounting for the effect of risks that net off on consolidation.

2 The PRA would not reflect such a difference in the consolidated group PRA buffer where the underlying risk of the entity established outside the United Kingdom is otherwise mitigated in the consolidated group requirements.

## Appendix 3: Draft amendments to Supervisory Statement 24/15 ‘The PRA’s approach to supervising funding and liquidity risks’

In this appendix, new text is underlined.

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### Transferability of funds

2.35 With regard to the risk that, in severely stressed circumstances, liquidity might not be freely transferable between and within group entities, across national borders, as well as between currencies, the PRA expects firms to demonstrate that the assumptions they make are realistic. Further to PRA Rulebook Internal Liquidity Adequacy Assessment Rule 8, firms should include detailed information, at all relevant levels of application of liquidity requirements, in their ILAAPs, on:

- (a) The distribution of outflows, inflows and liquid assets by location, with a breakdown by all significant currencies, as determined under the CRR;<sup>1</sup>
- (b) The distinction between intragroup and external inflows;
- (c) Where liquid assets are not aligned to net outflows by currency or by location, a consideration of how liquid assets located elsewhere in the group may be immediately available, with particular emphasis on:
  - (i) The ease with which liquid assets can be moved across legal entities and jurisdictions (including within the same legal entity, for example between a firm’s overseas branch and a firm’s head office);
  - (ii) The ease with which liquid assets can be moved across different time zones;
  - (iii) The ease with which liquid assets can be transferred from one currency into another (including the operational ease of monetisation);
  - (iv) The potential consequences of moving liquid assets across different legal entities and jurisdictions; and
  - (v) The entities, decision-making bodies and processes involved in the control of the movement of these liquid assets and the potential impact on the immediate availability of those liquid assets.
- (d) Where outflows at an individual (or sub-group) level are significantly covered by intragroup inflows, a consideration of the impact of stress on intragroup inflows.

2.35A Under the Senior Managers Regime,<sup>2</sup> firms are required to allocate a Prescribed Responsibility for managing the allocation and maintenance of the firm’s capital, funding and liquidity to an individual performing a senior management function (SMF).<sup>3</sup> The PRA expects:

<sup>1</sup> CRR Article 415(2) requires firms to report on a single currency basis, any currency which exceeds 5% of aggregate liabilities.

<sup>2</sup> See Rule 4.1(7) in the Allocation of Responsibilities part of the PRA Rulebook and PRA Supervisory Statement 28/15 ‘Strengthening individual accountability in banking’, May 2017.

<sup>3</sup> Typically the Chief Finance function (SMF2) or, depending on the organisational structure of a group, a Group Entity Senior Manager function (SMF7).

- the SMF who is allocated this Prescribed Responsibility to ensure that the firm conducts the assessment specified in paragraph 2.35 and documents it in the firm's ILAAP submissions; and
- firms to ensure this expectation is explicitly reflected in the relevant SMF's Statement of Responsibilities.

## Appendix 4: Draft instrument

### **PRA RULEBOOK: CRR FIRMS: INTERNAL CAPITAL ADEQUACY ASSESSMENT (No. X) INSTRUMENT [2017]**

#### **Powers exercised**

- A. The Prudential Regulation Authority (“PRA”) makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 (“the Act”):
  - (1) section 137G (The PRA’s general rules); and
  - (2) section 137T (General supplementary powers).
- B. The rule-making powers referred to above are specified for the purpose of section 138G(2) (Rule-making instrument) of the Act.

#### **Pre-conditions to making**

- C. In accordance with section 138J of the Act (Consultation by the PRA), the PRA consulted the Financial Conduct Authority. After consulting, the PRA published a draft of proposed rules and had regard to representations made.

### **PRA Rulebook: CRR Firms: Internal Capital Adequacy Assessment (No. X) Instrument [2017]**

- D. The PRA makes the rules in the Annex to this instrument.

#### **Commencement**

- E. This instrument comes into force on [DATE].

#### **Citation**

- F. This instrument may be cited as the PRA Rulebook: CRR Firm Internal Capital Adequacy Assessment (No. X) Instrument [2017].

**By order of the Prudential Regulation Committee**  
[DATE]

## Annex

In this Annex new text is underlined and deleted text is struck through

### Part

## INTERNAL CAPITAL ADEQUACY ASSESSMENT

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### 14 APPLICATION OF THIS PART ON AN INDIVIDUAL BASIS, A CONSOLIDATED BASIS AND A SUB-CONSOLIDATED BASIS

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14.10 A *firm* must also carry out the allocation in 14.8 ~~allocate the total amount of financial resources, *own funds* and internal capital identified as necessary under the overall Pillar 2 rule in 3.1 as applied on a *consolidated basis* or on a *sub-consolidated basis* between each *firm* which is a member of the *consolidated group* in a way that:~~

- (a) takes into account the nature, level and distribution of the risks between all entities within the *consolidation group*~~the amount allocated to each *firm* must be decided on the basis of the principles in 14.9; and~~
- (b) ensures the amount allocated to each *firm* adequately reflects the risks to which that *firm* is exposed on an individual basis if the process in (a) were carried out for each group member, the total so allocated would equal the total amount of financial resources, *own funds* and internal capital identified as necessary under the overall Pillar 2 rule in 3.1 as applied on a *consolidated basis* or on a *sub-consolidated basis*.