



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Consultation Paper | CP5/19

Pillar 2 capital: Updates to the framework

March 2019



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Responses are requested by Thursday 13 June 2019.

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1 Overview

1.1 In this consultation paper (CP), the Prudential Regulation Authority (PRA) proposes to update the Pillar 2 capital framework to reflect continued refinements and developments in setting the PRA buffer (also referred to as Pillar 2B).

1.2 Since the PRA published its approach to setting the PRA buffer,¹ the Bank of England's (Bank's) approach to stress testing has evolved. There have been changes to the stress testing hurdle rate and the way microprudential and macroprudential buffers interact. This in turn has implications for the way that the PRA buffer is calculated.

1.3 The PRA also proposes to clarify its approach to assessing weaknesses in risk management and governance, explain the process for updating the benchmarks used to calculate the Pillar 2A requirement for credit risk and correct some minor drafting errors that have been identified in previous publications.

1.4 This CP is relevant to PRA-authorized banks, building societies and PRA-designated investment firms ('firms'). This CP is not relevant to credit unions, insurance and reinsurance firms.

Background

1.5 The PRA buffer is an amount of capital that firms should maintain in addition to their total capital requirements² (TCR) to absorb losses that may arise under a severe stress scenario, while avoiding duplication with the combined buffers. It may also be increased where the PRA assesses a firm's risk management and/or governance (RMG) to be significantly weak.

1.6 In 2015, the PRA set out the methodologies used in setting Pillar 2 capital for firms.³ This document was the first significant step towards increasing the transparency of the Pillar 2 capital framework. The proposals in this CP offer further clarity on the way that the PRA buffer is set. The PRA is not proposing to alter the purpose of the PRA buffer through these changes.

Purpose

1.7 The purpose of these proposals is to bring greater clarity, consistency and transparency to the PRA's capital setting approach. In promoting a greater level of transparency, the PRA seeks to promote financial stability, the safety and soundness of PRA-authorized firms, and facilitate more informed and effective capital planning for banks.

Implementation

1.8 The PRA proposes to implement the proposals in the CP by Tuesday 1 October 2019.

1.9 The proposals set out in this CP have been developed in the context of the current UK and EU regulatory framework. The PRA has assessed that no additional amendments would need to be made to the proposals in this CP in the event that the UK leaves the EU with no Implementation Period in place on Friday 29 March 2019. Please see: PS5/19 'The Bank of England's amendments to financial services legislation under the European Union

1 'The PRA's methodologies for setting Pillar 2 capital', originally published in July 2015: <https://www.bankofengland.co.uk/prudential-regulation/publication/2015/the-pras-methodologies-for-setting-pillar-2-capital>.

2 TCR is the sum of pillar 1 plus pillar 2A capital requirements.

3 See footnote 1.

(Withdrawal) Act 2018⁴ for further information on the Bank's amendments to rules and standards under the European Union (Withdrawal) Act 2018; Bank of England Statement of Policy (SoP) 'Interpretation of EU Guidelines and Recommendations: Bank of England and PRA approach after the UK's withdrawal from the EU';⁵ and Supervisory Statement (SS) 1/19 'Non-binding PRA materials: The PRA's approach after the UK's withdrawal from the EU'.⁶

Responses and next steps

1.10 This consultation closes on Thursday 13 June 2019. The PRA invites feedback on the proposals set out in this consultation. The PRA is particularly interested in respondent's views on areas where further clarity is needed.

1.11 Please address any comments or enquiries to CP5_19@bankofengland.co.uk.

2 Proposals

2.1 The proposals in this CP cover:

- (a) the hurdle rate in stress;
- (b) buffer interactions and usability;
- (c) the risk management and governance assessment;
- (d) updating benchmarks for assessing Pillar 2A credit risk; and
- (e) minor corrections to drafting.

2.2 In order to implement the changes, the PRA proposes to update the following:

- SoP 'The PRA's methodologies for setting Pillar 2 capital', (Appendix 1);⁷
- SS31/15 'The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)', (Appendix 2);⁸ and
- SS6/14 'Implementing CRD IV: Capital buffers', (Appendix 3).⁹

Hurdle rate

2.3 The hurdle rate is the minimum level of capital that a firm is expected to meet or exceed in a severe but plausible stress.

⁴ February 2019: <https://www.bankofengland.co.uk/paper/2019/the-boes-amendments-to-financial-services-legislation-under-the-eu-withdrawal-act-2018>.

⁵ February 2019: <https://www.bankofengland.co.uk/paper/2019/interpretation-of-eu-guidelines-and-recommendations-boe-and-pra-approach-sop>.

⁶ February 2019: <https://www.bankofengland.co.uk/prudential-regulation/publication/2019/non-binding-pra-materials-the-pras-approach-after-the-uks-withdrawal-from-the-eu-ss>.

⁷ April 2018: <https://www.bankofengland.co.uk/prudential-regulation/publication/2015/the-pras-methodologies-for-setting-pillar-2-capital>.

⁸ March 2019: <https://www.bankofengland.co.uk/prudential-regulation/publication/2013/the-internal-capital-adequacy-assessment-process-and-supervisory-review-ss>.

⁹ April 2014: <https://www.bankofengland.co.uk/prudential-regulation/publication/2014/implementing-crdiv-capital-buffers-ss>.

2.4 This CP explains how systemically important firms should be held to a higher standard during the stress, and the PRA's proposed new approach for including Pillar 2A in the hurdle rate.

Reflecting systemic importance

2.5 The SoP already notes the PRA's intention to hold systemically important firms to a higher standard. The Financial Policy Committee (FPC) and the Prudential Regulation Committee (PRC) have given further consideration to how this should be done. To ensure systemically important firms are held to a higher standard, the systemic buffer would be included in the hurdle rate in the stress test.

2.6 Including the systemic buffers in the hurdle rate used in the stress test would reduce the probability of failure of systemically important firms without impeding buffer usability under stress conditions. Systemic buffers do not form part of minimum capital and remain available to absorb losses in a stress.

2.7 Appendix 1 details the proposed updates to the SoP in paragraphs 9.7-9.8.

Reflecting the evolution of Pillar 2A over time

2.8 As part of stress testing, the PRA looks at the evolution of TCR and hurdle rates over a five year horizon under a stress scenario. Projecting the Pillar 2A element over the duration of a stress test can be challenging, for example due to stress-related changes in the risks reflected in Pillar 2A. For simplicity, the Pillar 2A element of the hurdle rate has typically been set as a constant¹⁰ share of total risk-weighted assets (RWAs) over the stress test horizon.

2.9 However, many of the risks reflected in Pillar 2A are not in practice closely related to the size of a firm's total RWAs. Any divergence between the underlying Pillar 2A risks and total RWAs can be expected to grow as stress conditions take hold (eg over the five year horizon of the stress test).

2.10 To ensure Pillar 2A requirements in the stress test better reflect the probable impact of the stress on capital requirements, each Pillar 2A risk component would scale with an appropriate base. For example, Pillar 2A requirements for credit risk would scale with changes in credit RWAs rather than total RWAs. The scaling bases are set out in Table 1.

2.11 This approach would also preserve, as far as is possible, the current simplicity in the calculation of the hurdle rate.

2.12 These scaling bases are not intended to be specific guidance on how the PRA will set Pillar 2A requirements if a similar scenario to the stress unfolds in practice.

2.13 Table 1 covers the material risks captured by Pillar 2A requirements for the firms participating in the annual stress test. For other risks, the PRA would consider the most appropriate scaling base to apply while maintaining the simplicity of the calculation.

¹⁰ With the exception of pension risk which is expressed as a nominal (£) amount.

Table 1

| Risk type | Scaling base |
|---|--|
| Operational risk ¹¹ | Total assets or leverage exposure measure ¹² |
| Pension risk | No scaling – remains a fixed add-on |
| Interest rate risk in the banking book (IRRBB) | Total banking book assets or Leverage exposure measure ¹³ |
| Credit concentration risk | Pillar 1 credit risk weighted assets |
| Market and counterparty credit risk ¹⁴ | Pillar 1 market risk weighted assets |
| Credit risk | Pillar 1 credit risk weighted assets |
| RFB group risk | No scaling – remains a fixed add-on |
| Other risks | As appropriate |

2.14 The PRA proposes that all firms, including those not participating in the annual stress tests, may choose to consider the new approach when conducting the stress tests as part of their Internal Capital Adequacy Assessment Process (ICAAP).

2.15 Appendix 1 details the proposed updates to the SoP in paragraphs 9.24-9.26.

Buffer interactions and usability

2.16 The PRA proposes to make the interaction between the PRA buffer and the combined buffers¹⁵ clearer. As part of that, a new illustration of the capital stack¹⁶ is included in the SoP (see Figure 1). The interactions between each of the buffers are outlined below.

Buffer interactions

2.17 The PRA buffer and the capital conservation buffer (CCoB) aim to ensure that firms can meet their minimum capital requirements in a severe but plausible stress. The purpose of these two buffers overlap. To avoid double counting, the component of the PRA buffer that relates to the impact of the stress is calculated as the excess amount of capital required over and above the CCoB.

2.18 The countercyclical capital buffer (CCyB) is set to capture system-wide cyclical risk while the PRA buffer captures firm-specific or idiosyncratic risk. The CCyB is informed by the Bank's

¹¹ Including information technology risk.

¹² The PRA will assess the appropriate scaling base to be used.

¹³ The PRA will assess the appropriate scaling base to be used.

¹⁴ The Pillar 2A requirement for counterparty credit risk typically relates to the market risk aspect of counterparty credit risk. The credit risk component would typically be captured in credit concentration risk requirements.

¹⁵ The combined buffer comprises the Capital Conservation Buffer (CCoB), the Countercyclical Buffer (CCyB), the buffer for global and other systemically important institutions (G-SIIs and O-SIIs) and (for ring-fenced banks and the largest building societies) the Systemic Risk Buffer (SRB).

¹⁶ This is a visual representation of the loss absorbing capacity firms are required to hold to ensure they maintain enough capital to absorb losses for when faced with systemic or firm specific risk in a going concern framework.

annual stress test. The PRA buffer will therefore generally be the amount of excess capital firms need to withstand the stress over and above the CCyB.

2.19 Changes to buffers applied for macroprudential purposes (outside of stress testing) will always be additive to a firm's existing PRA buffer.

2.20 The PRA buffer is additive to systemic buffers. That is because the same stress test severity is applied to all firms so the PRA buffer does not reflect the higher costs a systemically important firm's failure would impose on the real economy. This ensures systemically important firms are held to a higher standard.

2.21 Appendix 1 details the proposed updates to the SoP in paragraphs 9.31-9.34.

Usability of buffers

2.22 Like the combined buffer, the PRA buffer can be used to absorb losses in a stress. When this happens, the PRA will be content for firms to rebuild their buffers over a reasonable period of time. In exercising its judgement on what constitutes a reasonable time to rebuild buffers drawn down in stress, the PRA will take into account the amount by which the buffer has been used and the expected duration of the stress. The PRA will consider the firm-specific drivers for using the PRA buffer within the current and forecast macroeconomic and financial conditions. The PRA does not expect firms to maintain additional capital to avoid using the PRA buffer or combined buffers in a stress.

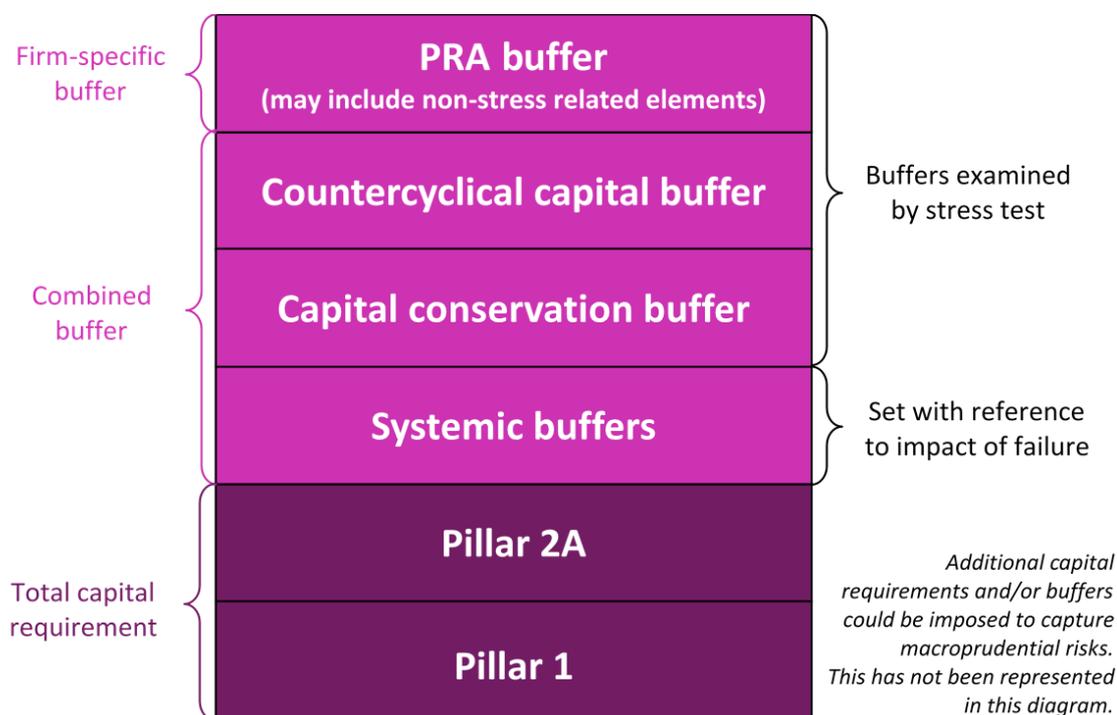
2.23 The PRA proposes to update the information expected from firms which reflects that the PRA buffer is usable. The information expected from firms includes the timeframe over which the PRA buffer would be restored.

2.24 Appendix 1 details the proposed updates to the SoP in paragraph 9.5, Appendix 2 details the updates to SS31/15 in paragraphs 3.31 and 3.33 and Appendix 3 details the proposed updates to SS6/14 in paragraphs 5.33-5.35.

Capital Stack

2.25 Given the interaction of the buffers set out above, the PRA proposes to include a new illustration of the capital stack (see Figure 1 below) which more accurately reflects the framework.

Figure 1: Proposed capital stack



2.26 Appendix 1 details the proposed updates to the SoP in paragraph 9.1.

Risk management and governance assessment

2.27 Where the PRA assess a firm's risks management and/or governance to be significantly weak, it may set an RMG capital scalar. This scalar forms part of the PRA buffer. It is always additive to the combined buffer. In this CP, the PRA proposes to clarify the process for setting a scalar.

2.28 Before applying a scalar, the PRA may apply what is commonly referred to as a 'suspended scalar'. Depending on the severity of the weaknesses identified in a firm's risk management and/or governance, and the proposed remediation actions, the PRA may allow the firm time to address the identified weaknesses before applying a scalar. In these circumstances, the PRA may give the firm an indicative figure for the size of the scalar that could be applied.

2.29 The firm would not need to maintain any additional capital but outcomes or actions would need to be agreed to prevent a scalar being applied. If a scalar is applied, the amount may vary from the indicative figure as it will be based on the facts at the time of application.

2.30 Appendix 1 details the proposed update to the SoP in paragraph 9.36.

Updating benchmarks for assessing Pillar 2A credit risk

2.31 The PRA uses benchmarks based on firms' internal rating based (IRB) approach average risk weights when assessing Pillar 2A capital for credit risk. The PRA is/has committed to

monitoring changes in IRB risk weights on a regular basis. The PRA noted it would consider updating the benchmark if significant movements in risk weights are observed.¹⁷

2.32 In line with this commitment, the PRA has considered movements in IRB risk weights. The PRA considers that an update of the published IRB benchmark is not necessary at this time.

2.33 The PRA is proposing to update the benchmark when significant movements are observed in the IRB risk weights. This could result in a full or partial update to the benchmark. For example, there may be a partial update where risk weights have moved in a way that impacts one asset class, as opposed to all asset classes.

2.34 The PRA acknowledges that frequent updates may transmit volatility in IRB risk weights to the capital requirements for standardised approach firms. The PRA proposes to limit excessive volatility by smoothing out changes, for example through the use of multi-year averages over time.

2.35 Appendix 1 details the proposed update to the SoP in paragraph 2.13A.

Minor corrections to drafting

2.36 The PRA proposes to add clarity to the PRA buffer setting process. The explanations do not change the way that PRA buffer is currently set. The PRA expects that the updates will increase transparency and improve understanding.

2.37 The PRA also proposes to use this opportunity to correct typos and to change references that no longer apply.

2.38 The proposal for changes to the SoP are listed below:

- correct range from 60% to 50%¹⁸ in the IRB risk benchmark (excluding expected losses) for commercial real estate (CRE) in Table A2; and
- change of 'available for sale' into 'fair value through other comprehensive income (FVOCI)' in the market risk methodology.

2.39 The proposals for changes to SS31/15 are to:

- delete reference to GENPRU in paragraph 4.5;
- change should to could in paragraph 4.7;
- correct typos in paragraph 3.16, 5.14, 5.22 and 5.37;
- clarification to the concentration risk adjustments in paragraph 5.12B; and
- delete the transitional arrangements section for the phase-in of the quality of capital (paragraphs 5.26 to 5.30).

¹⁷ Para, 2.25, PRA Policy Statement 22/17, 'Refining the PRA's Pillar 2A capital framework', October 2017: <https://www.bankofengland.co.uk/prudential-regulation/publication/2017/refining-the-pra-pillar-2a-capital-framework>.

¹⁸ As set out in the Capital Requirements Regulation (575/2013) Articles 153(5) and 158(6).

3 The PRA's statutory obligations

3.1 In carrying out its policy making functions, the PRA is required to comply with several legal obligations.

3.2 Before making any rules, the Financial Services and Markets Act 2000 (FSMA)¹⁹ 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,²⁰ insurance objective²¹ (if applicable), and secondary competition objective;²²
- 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;²³ and
- a statement as to whether the impact of the proposed rules will be significantly different to mutuals than to other persons.²⁴

3.3 The PRC should have regard to aspects of the Government's economic policy as recommended by HM Treasury.²⁵

3.4 The PRA is also required by the Equality Act 2010²⁶ to have due regard to the need to eliminate discrimination and to promote equality of opportunity in carrying out its policies, services and functions.

Cost benefit analysis

3.5 This CP sets out the PRA's proposed changes to the SoP with the aim of improving the clarity and transparency of its PRA buffer policy. This should benefit firms and market participants.

Hurdle rate

3.6 The proposal to clarify that systemic buffers are included in firms' hurdle rate should not lead to any changes in firms' overall regulatory buffers, as PRA buffers are already additive to systemic buffers. Therefore there is no cost associated with this proposal, for firms or the PRA.

3.7 Clarifying the inclusion of systemic buffers in the hurdle rate delivers transparency benefits, as it provides detail on how we hold systemic firms to a higher standard, a commitment made in the SoP. This furthers the PRA's first objective of ensuring safety and soundness.

¹⁹ Section 138J of FSMA.

²⁰ Section 2B of FSMA.

²¹ Section 2C of FSMA.

²² Section 2H(1) of FSMA.

²³ Sections 2H(2) and 3B of FSMA.

²⁴ Section 138K of FSMA.

²⁵ Section 30B of the Bank of England Act 1998.

²⁶ Section 149.

3.8 The proposal for the new approach to including Pillar 2A in the stress impact reflects a clarification of existing policy for firms participating in the annual stress test and an extension of the policy for all firms to consider the approach in their ICAAPs.

3.9 The PRA would apply the approach as part of the Supervisory Review and Evaluation Process (SREP), thus there is no additional cost to firms. For firms considering this as part of their ICAAP, the costs should be minimal as the information used is already being captured and submitted. For non-systemic firms, the PRA does not impose a particular way to calculate the hurdle rate in internal ICAAP stress tests. For those that do follow the PRA's methodology, the impact of buffers would depend on the risk-type composition of their Pillar 2A, their approach to calculating risk weights, and actions such as changes in lending under a stress.

3.10 It is beneficial to firms and the market that both approaches are clarified, as it ensures that the methodology for calculating PRA buffers is transparent and well understood.

Buffer interactions and usability

3.11 The proposed clarification on the function of the PRA buffer, the combined buffer and the PRA's expectations is aimed at improving firms' and market participants' understanding about the purpose of capital buffers, how the PRA buffer is set and how it interacts with the combined buffer. The clarifications aim to provide further clarity on the circumstances under which capital buffers are intended to be used and the factors the PRA would consider when evaluating firms' plans to rebuild them. This improved clarity would benefit firms and market participants, as they would better understand PRA expectations, in turn reducing any regulatory uncertainty and compliance costs.

3.12 Reducing uncertainties about capital buffers and their use may also facilitate more efficient capital planning, by allowing firms to estimate more accurately the amount of regulatory capital that the PRA expects firms to maintain during both normal and more stressful economic conditions. This could reduce any disincentives on firms to use capital buffers in times of stress, which could help reduce the risk that lending capacity is unduly constrained during such times, mitigating potentially negative (procyclical) feedback effects that could ensue.

3.13 There is no cost associated with the proposed drafting changes or amending the capital stack.

RMG assessment

3.14 The proposal to clarify the use of suspended scalars would improve transparency and understanding of the PRA's assessment process. The proposal has no cost implications for firms or the PRA as the overall process for applying RMG scalars is already clear in the policy and remains unchanged.

The IRB benchmark to assess Pillar 2A credit risk

3.15 The proposal to clarify the process for updating the benchmarks would improve transparency and understanding of the PRA's assessment process. The proposal has no cost implications for firms or the PRA as a review process is already in place.

Minor corrections to drafting

3.16 The proposed drafting changes to the SoP and SS31/15 have the benefit of improving transparency and reliability. The PRA's approach to setting the PRA buffer has evolved over the

years. The changes would bring the SoP up to date and provide clarity. This has direct benefits for firms and the wider market, as well as the PRA.

3.17 There are no cost implications of this proposal to firms or the PRA. None of the drafting changes reflect new or amended policy.

Compatibility with the PRA's objectives

3.18 In discharging its general functions of determining the general policy and principles by reference to which it performs particular functions, the PRA must, so far as reasonably possible, act in a way that advances its general objective to promote the safety and soundness of the firms it regulates. These proposals advance the PRA's general objective by improving the clarity and transparency of its PRA buffer policy and removing uncertainty over the PRA's regulatory capital regime.

3.19 When discharging its general function in a way that advances its primary objectives, the PRA has, as a secondary objective, to facilitate effective competition. These proposals help advance that objective by providing firms and financial markets (including investors, analysts and depositors) with greater clarity on the PRA buffer policy which could help to make firms' capital management practices more efficient and support more efficient decisions on the allocation of financial resources.

Regulatory principles

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

3.21 The first is the principle that the PRA should exercise its functions as transparently as possible. The PRA considers that the proposals outlined in this CP would bring greater clarity and transparency to the PRA's capital framework in line with this principle.

3.22 The second is the principle that a burden or restriction which is imposed on a person, or on the carrying out 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 PRA has followed this principle when developing the proposals outlined in this CP. The PRA considers that the benefits from improving the clarity of its approaches to setting the PRA buffer and the usability of the PRA buffer outweigh any implementation burden or cost to firms.

Impact on mutuals

3.23 In accordance with FSMA, the PRA has assessed the impact of its proposals on mutuals. The PRA considers that the impact of the proposed rule changes on mutuals is expected to be no different from the impact on other firms.

HM Treasury recommendation letter

3.24 HM Treasury has made recommendations to the PRC about aspects of the Government's economic policy to which the PRC should have regard when considering how to advance the PRA's objectives and apply the regulatory principles.²⁷ The PRA has considered these

²⁷ Information about the PRC and the recommendations from HM Treasury are available on the Bank's website at <https://www.bankofengland.co.uk/about/people/prudential-regulation-committee>.

recommendations in the 'compatibility with the PRA's objectives' and 'regulatory principles' sections above.

Equality and diversity

3.25 The PRA is also required by the Equalities Act 2010 to have due regard to the need to eliminate discrimination and to promote equality of opportunity in carrying out its policies, services and functions. The PRA has performed an assessment of the policy proposals and does not consider that the proposals give rise to equality and diversity implication.

Appendices

| | | |
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| 1 | Draft amendments to SoP 'The PRA's methodologies for setting Pillar 2 capital' | 13 |
| 2 | Draft amendments to SS31/15 'The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)' | 23 |
| 3 | Draft amendments to SS6/14 'Implementing CRD IV: Capital buffers' | 27 |

Appendix 1: Draft amendments to Statement of Policy ‘The PRA’s methodologies for setting Pillar 2 capital’

This appendix outlines proposed amendments to Chapter 2 on credit risk and Chapter 9 on the PRA buffer of ‘SoP - The PRA’s methodologies for setting Pillar 2 capital’.

Underlining indicates new text and striking through indicates deleted text. Please note that footnote references will be updated when the final policy is published.

...

Section I: Pillar 2A methodologies

2 Credit risk

...

2.13A The PRA will monitor changes in IRB risk weights at least annually. Where significant changes are observed, the PRA will consider updating the IRB benchmark. This may include a partial update if this is only relevant for selected asset classes. In considering updates to the benchmarks, the PRA will look to: minimise the lag between the data used to calculate the benchmark and its application to firms; and limit excessive volatility by smoothing out changes (for example, through the use of multi-year averages).

...

Table A2 Credit risk IRB benchmark – excluding expected losses

| | SA RW | Exposure weighted average risk weight | Lower range RW ^(a) | Upper range RW ^(a) |
|--|-------|---------------------------------------|-------------------------------|-------------------------------|
|--|-------|---------------------------------------|-------------------------------|-------------------------------|

...

Commercial real estate

| | | | | |
|------------------------------------|-----------------------|---|--|--|
| Commercial real estate development | 100/150% ³ | Risk weights can vary between 60% 50% and 250% which represents the full range of risk weights outlined by CRR Articles 153(5) and 158(6). | | |
| Commercial real estate investment | 100% | | | |

...

3 Market risk

3.3 The Pillar 2A approach to market risk applies to all firms and covers all positions in the trading and ~~available-for-sale~~ fair value through other comprehensive income (FVOCI) books, including securitisation instruments/positions and covered bonds booked in the trading and FVOCI ~~available-for-sale~~ books.

...

In Section II, Chapter 9 has been removed in its entirety and replaced with the text shown below. The text is not underlined.

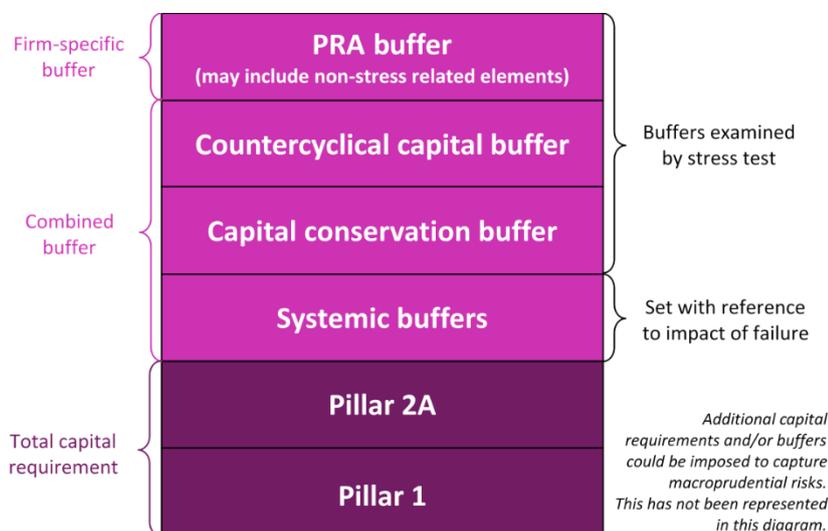
Section II: The ‘PRA buffer’ (Pillar 2B)

9 The PRA buffer

Purpose and objective of the PRA buffer

9.1 The PRA buffer (also referred to as Pillar 2B) is an amount of capital firms should maintain in addition to their total capital requirement¹ (TCR) and the combined buffer. Together the PRA buffer, the combined buffer² and the TCR makes up the PRA’s capital framework as illustrated by the capital stack in Figure 2.

Figure 2 - The capital stack



¹ Total capital requirements is the sum of Pillar 1 capital requirements plus Pillar 2A capital requirements.

² The combined buffer comprises the Capital Conservation Buffer (CCoB), the Countercyclical Buffer (CCyB), the buffer for global and other systemically important institutions (G-SIIs and O-SIIs) and (for ring-fenced banks and the largest building societies) the Systemic Risk Buffer (SRB).

9.2 Firms should maintain capital to meet their TCR (regulatory minimum) at all times. Firms also maintain capital in the PRA buffer and the combined buffer for use (either immediately or in the future) to withstand the impact of a severe but plausible stress.

9.3 The PRA buffer is set using three assessments:

- (a) the ‘stress impact’ - an assessment of the amount of capital firms should maintain to withstand a severe stress scenario;
- (b) the ‘risk management and governance assessment’ - an assessment of whether a firm has significant risk management and governance (RMG) weaknesses; and
- (c) ‘supervisory judgment’ – an assessment of any other relevant information to inform adjustments to the PRA buffer in order to protect the safety and soundness of firms.

9.4 All components of the PRA buffer including RMG should be met by CET1 capital.

9.5 The PRA considers that all buffers in the capital framework, including the PRA buffer, can be used as required in times of stress. When this happens, the PRA will be content for firms to rebuild their buffers over a reasonable period of time. In exercising its judgement on what constitutes a reasonable time to rebuild buffers drawn down in stress, the PRA will take into account the amount by which the buffer has been used and the expected duration of the stress. It will consider any firm-specific drivers of the use of the buffer, in the context of current and forecast macroeconomic and financial conditions. There is no expectation on firms to maintain additional amounts of capital to avoid being within the PRA buffer in the event of a stress. More detail on the PRA’s response to firms using buffers can be found in SS31/15.³

Setting the PRA buffer

9.6 The frequency of assessment of the PRA buffer is aligned to firms’ SREP cycle; annually for major UK firms, and every two to three years for other firms. The PRA may reassess the PRA buffer more frequently when a firm’s circumstances change. For example a change in business model or strategy, a material change in a firm’s risk profile, or when RMG weaknesses are either identified or resolved.

9.7 Together the combined buffer and PRA buffer (the component relating to the stress impact) aim to ensure firms’ capital is at a level to withstand the impact of a suitably severe stress. The PRA buffer captures firm-specific risks and is set with reference to a firm’s hurdle rate. The hurdle rate is the level of CET1 capital firms are expected to maintain throughout the economic cycle and in a severe but plausible stress. The severity of the scenario (ie severe but plausible) is common to all firms and the Bank and PRA publishes benchmarks for the appropriate severity of the scenario firms should consider.

9.8 Unlike the severity of the scenario, the hurdle rate is not common across firms. For most firms the hurdle rate is their TCR. For firms considered systemically important the hurdle rate includes their systemic buffers on top of their TCR. This is consistent with international expectations of holding systemically important firms to higher standards. Firms would still be able to use their systemic buffers to absorb the impact of a stress.

³ ‘The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)’, March 2019: <https://www.bankofengland.co.uk/prudential-regulation/publication/2013/the-internal-capital-adequacy-assessment-process-and-supervisory-review-ss>.

9.9 TCR refers to the minimum requirement applicable to all tiers of capital. CET1 capital may be required to cover any shortfalls in AT1 / T2 capital, including those projected under the stress scenario, before it can count towards the buffers or considered excess CET1 capital.

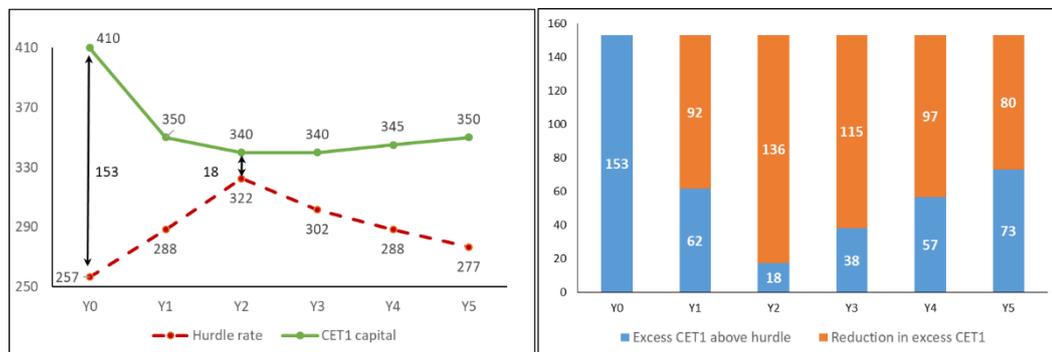
9.10 The PRA may make some adjustments to reflect International Financial Reporting Standards (IFRS) 9 provisions.⁴

Stylised example

9.11 The amount of CET1 capital needed to maintain a firm's capital levels above the hurdle rate throughout the economic cycle is the largest reduction (relative to the starting point of the stress) in excess CET1 capital above the hurdle rate.⁵ Figure 3 is an illustrative example of the calculation. The left panel shows the projected CET1 capital resources and hurdle rate of a firm in a stress scenario. At each reporting point, the excess CET1 capital above the hurdle rate is calculated (blue bars in the right panel). The year with the smallest excess capital (year 2) is where the stress impact on the firm's capital level is greatest.

9.12 In the example of Figure 3 the total amount of CET1 capital to hold now to ensure the firm's capital level remains above the hurdle rate is the largest reduction in excess CET1 capital above the hurdle rate (orange bar) in year 2, ie 136. Assuming the capital conservation buffer (CCoB) is 94 (2.5% of RWAs) and the countercyclical capital buffer (CCyB) is set as 19 (0.5% of RWAs), the amount of CET1 capital not covered by the CCoB and the CCyB is the PRA buffer, i.e. 136 minus 94 minus 19 = 23 (0.6% of RWAs).

Figure 3 Calculation of the PRA buffer – Illustrative example



Stressed CET1 capital resources and hurdle rate (left panel). Excess CET1 capital above hurdle rate and reduction in excess CET1 capital relative to starting point (right panel).

9.13 Where a buffer⁶ for an entity established outside the UK exceeds that entity's share⁷ 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

⁴ IFRS 9 was issued in July 2014 and sets out new rules for accounting for financial instruments, replacing the rules in International Accounting Standard (IAS) 39. Following endorsement for use in the EU, IFRS 9 is effective for annual periods beginning on or after 1 January 2018. The PRA's communications to firms on IFRS 9 are available on the Bank's website at <https://www.bankofengland.co.uk/prudential-regulation/letter/2017/transition-disclosures-for-ifs9-financial-instruments>.

⁵ The illustrative example assumes the firm does not breach the hurdle rate and has excess CET1 throughout the stress. The cases of a projected CET1 shortfall will add to the PRA buffer calculation.

⁶ 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.

⁷ 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.

institution established outside the United Kingdom is otherwise mitigated in the consolidated group requirements.

9.14 Where a particular buffer applicable on a sub-consolidated basis for the RFB sub-group is higher than the RFB sub-group's share⁸ of the corresponding buffer on a consolidated basis, the difference will generally be considered in the setting of the consolidated group's PRA buffer. This is to reflect the associated RFB group risk at the consolidated group level.

The stress impact

9.15 The PRA carries out an assessment of firms' internal/ICAAP stress testing as part of the SREP.⁹ For the major UK firms this is supplemented by the Bank's annual stress test.¹⁰

9.16 The assessment considers the credibility and reasonableness of firms' projected stress results and the underlying assumptions on which the stress projections are build. The assessment focusses on the areas where the stress scenario adversely impacts firms' capital positions, ie reducing capital resources and increasing capital requirements, the nature and severity of the scenario on which the stress results are based and the reasonableness of mitigating actions firms propose to mitigate the impact of the stress.

9.17 Firms' assumptions, choice of scenario and stress projections are analysed and compared against the PRA's own internal models, peer benchmarks and information submitted in their ICAAPs. Where the PRA has concerns around the credibility of firms' stress results, adjustments will be made to the results or to the PRA buffer.

9.18 Other factors taken into account when assessing firms' financial health and risk profiles under stress include, but are not limited to: the firm's leverage ratio; Tier 1 and total capital ratios; risks associated with double leverage; and the extent to which potentially significant risks are not captured fully as part of the stress test. Until the end of 2023, the PRA will also assess firms' capital positions under transitional arrangements for IFRS 9, where firms are using these arrangements.

Stress scenario

9.19 The Bank publishes the stress scenario that major UK firms should consider in the Bank's annual stress test exercise.

9.20 For firms that are not part of this annual stress test the PRA regularly publishes scenarios to serve as a guide when designing their own scenarios for ICAAPs.¹¹ These scenarios provide a benchmark for the appropriate severity and nature of stress scenarios to be considered and ensure consistent assessments across firms.¹²

⁸ 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.

⁹ Stress testing and scenario analysis requirements are set out in Chapter 12 of the Internal Capital Adequacy Assessment rules and in Chapter 3 of the SS31/15 'The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)': <https://www.bankofengland.co.uk/prudential-regulation/publication/2013/the-internal-capital-adequacy-assessment-process-and-supervisory-review-ss>.

¹⁰ <https://www.bankofengland.co.uk/stress-testing>.

¹¹ <https://www.bankofengland.co.uk/stress-testing>.

¹² The PRA may also ask firms to run additional sensitivity analyses, the purpose of which will be to explore the impact on portfolios and/or regions, which are not covered in the PRA's published scenarios or the firms' idiosyncratic scenarios. The results of these sensitivity tests may be used to adjust the assessment of the stress impact

9.21 The assessment of firms' stress testing includes an analysis of the severity of the stress scenario considered by firms for the purposes of calculating the PRA buffer and the reasonableness of the stressed projections of the associated economic/market indicators that are part of the scenario expansion.

Capital resources in stress testing

9.22 Capital resources are expected to reduce in a stress scenario driven by reduced income and lower profitability, as a result of increased losses, and adverse movements in capital deductions.

9.23 The assessment of stressed capital resources includes an analysis of firms' income and impairment projections, the reasonableness of the balance sheet assumptions under stress, the stressed projections of potential misconduct costs beyond those already paid or provided for, (if relevant for an individual firm) and the credibility of the projections of stressed capital resources.

Capital requirements in stress testing

9.24 In a stress, capital requirements are expected to change as a result of changes in balance sheets and a deteriorating economic environment. Pillar 2A covers a range of risks not addressed under Pillar 1 (eg concentration risk, interest rate risk in the banking book) or not adequately addressed under Pillar 1 (eg operational risk). While Pillar 2A is typically expressed as a share of risk-weighted assets, the nature of some of these risks (eg pension deficit risk) is not related to RWAs and may evolve differently from RWAs in stressed conditions.

9.25 To reflect the evolution of the Pillar 2A requirements in a stress the PRA scales each of the Pillar 2A risk components with a suitable metric considered to be an underlying driver (or closely related to an underlying driver) of the particular risk type (see Table E). For example, Pillar 2A requirements for credit risk will scale with changes in credit RWAs rather than total RWAs.

9.26 These scaling bases do not reflect the way the PRA sets Pillar 2A requirements. Rather, they provide a simple way to ensure Pillar 2A requirements in the stress test reflect more closely the probable impact of the stress on the risks captured in Pillar 2A.

Table E – Pillar 2A scaling bases¹³

| Risk type | Scaling base |
|---|--|
| Operational risk ¹⁴ | Total assets or leverage exposure measure ¹⁵ |
| Pension risk | No scaling – remains a fixed add-on |
| Interest rate risk in the banking book (IRRBB) | Total banking book assets or leverage exposure measure ¹⁶ |
| Credit concentration risk | Pillar 1 credit risk weighted assets |
| Market and counterparty credit risk ¹⁷ | Pillar 1 market risk weighted assets |
| Credit risk | Pillar 1 credit risk weighted assets |
| RFB group risk | No scaling – remains a fixed add-on |
| Other risks | As appropriate |

Management actions

9.27 The PRA recognises management actions that firms could and would realistically take to mitigate the impact of the stress scenario. Guidance on management actions is provided in SS31/15. Additional expectations on management actions for the major UK firms participating in the Bank’s annual stress test are published on the Bank’s website.¹⁸

9.28 When assessing the credibility of the management actions, the PRA will consider the following:

- a) the credibility of the actions in the hypothetical stressed market conditions;
- b) any effects management actions could have on firms’ reputation with its counterparties, investors and customers;
- c) the main risks associated with executing these actions;
- d) the time required to implement actions and for these to take effect; and
- e) whether or not a firm has a proven track record of executing management actions or similar actions.

¹³ Table E covers the material risks captured by Pillar 2A requirements for the firms participating in the annual stress test. For other risks, the PRA will consider the best scaling base to apply while maintaining the simplicity of the calculation.

¹⁴ Including information technology risk.

¹⁵ The PRA will assess the appropriate scaling base to be used.

¹⁶ The PRA will assess the appropriate scaling base to be used.

¹⁷ The Pillar 2A requirement for counterparty credit risk typically relates to the market risk aspect of counterparty credit risk. The credit risk component would typically be captured in credit concentration risk requirements.

¹⁸ <https://www.bankofengland.co.uk/stress-testing>.

9.29 The firms participating in the Bank's annual stress test are expected to meet the projected demand for credit from UK households and businesses in the stress. This may limit the management actions recognised by the PRA in this context.

9.30 The credibility of capital related management actions such as the issuance, redemption and amortisation of additional Tier 1 (AT1) and Tier 2 capital instruments will be considered against the planned capital exercises in firms' baseline projections. The feasibility, timing and pricing of the issuances and redemptions in the stress scenario will be considered.

Overlaps with the combined buffer

9.31 Together the CCoB and the CCyB aims to ensure the banking system as a whole has sufficient capital to absorb system-wide losses that could occur in stress.¹⁹ The CCoB applies to all firms and establishes a basic level of capacity across the system to absorb losses. The CCyB aims to ensure that the banking system is able to withstand the stress throughout the cycle without restricting essential services, such as the supply of credit.²⁰

9.32 The PRA buffer aims to ensure that firms can meet their TCR in a severe but plausible stress. A portion of the amount of capital firms would need to meet their TCR in stress is therefore already captured by the CCoB and CCyB. To avoid double counting between the buffers, the component of the PRA buffer that relates to the impact of the stress is calculated as the excess amount of capital required over and above the CCoB and CCyB to withstand a severe but plausible stress.

9.33 The PRA considers there to be no overlap between the systemic buffers and the other buffers.

9.34 Changes in buffers applied for macroprudential purposes (outside of stress) will always be additive to firms' existing PRA buffers; this includes the CCyB, systemic buffer and any sectoral capital buffers. For example, if the FPC increases the CCyB rate by 0.25%, PRA buffers do not change.

The risk management and governance assessment (RMG)

9.35 Where the PRA assesses a firm's RMG to be significantly weak, it may also set the PRA buffer to cover the risks posed by those weaknesses until they are addressed. This will generally be calibrated in the form of a scalar applied to the amount of CET1 required to meet the TCR. The scalar could be up to 40% of the total CET1 TCR (variable).

9.36 Depending on the severity of the weaknesses identified and the proposed remediation actions, the PRA may allow the firm time to address the identified weaknesses before applying a scalar. In these circumstances, the PRA may give the firm an indicative figure for the size of the scalar – often referred to as a 'suspended scalar'. If a scalar is applied, the amount may vary from the indicative figure as it will be based on the facts at the time of application.

9.37 If an RMG scalar is included in the PRA buffer, RMG weaknesses identified in specific risk categories would not ordinarily be reflected in Pillar 2A capital requirements for those categories.²¹ Once the identified weaknesses have been remedied, the scalar should be removed. If new weaknesses emerge that are not adequately addressed by the scalar or if previous remedial action taken by the firm has led to its removal a new scalar may be applied.

¹⁹ Supplement to FSR Dec 2015.

²⁰ FPC framework for SRB.

²¹ An exception might be if the risk were only partially addressed by the imposition of a scalar.

9.38 To ensure consistency, RMG scalar decisions will be subject to a peer review process within the PRA.

Group risk

9.39 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 established outside the United Kingdom exceeds that entity's share of the buffer applicable at the consolidated group level to cover the same risk.^{22,23}

9.40 The PRA's assessment of the total amount of the PRA buffer applicable to the consolidated group will be informed by:

- (a) when setting the PRA buffer, the PRA will consider group risk. This will be informed by: for systemically important institutions, the amount by which any SRB exceeds the RFB sub-group's share of any buffer for global systemic importance (the G-SII buffer) at the consolidated group level. If the G-SII buffer is zero, RFB group risk will be informed by the full amount of any SRB, taking account of the RFB sub-group's size relative to the consolidated group; and
- (b) the amount by which any other buffer (such as the PRA buffer and including the RMG scalar) applicable to the RFB sub-group is higher than its share of the corresponding buffer for the consolidated group.

Overall supervisory judgement

9.41 While supervisory judgement may be applied at all levels of the assessment process, a number of specific areas are outlined below. The PRA may use any appropriate information to inform adjustments to firms' PRA buffers.

Impact of projections under the base case

9.42 Firms are expected to be able to meet their combined buffer²⁴ and PRA buffers under the base case. Where a firm's CET1 capital falls short of meeting the PRA buffer in the base case, the PRA's response will depend on the situation, but will most likely include a request for a revised capital plan to improve its stress resilience.

Post-balance sheet adjustments

9.43 The PRA buffer calculation is dependent on the firms' balance sheet used to complete the ICAAP. At the time the PRA buffer is set the firms' balance sheet may have materially changed, eg disposals and/or acquisitions. Where this has occurred adjustments will be made ensuring capital requirements remain consistent with a firm's balance sheet risks.

Weaknesses in stress testing processes and data quality

9.44 Supervisors consider the adequacy of a firm's stress testing processes, the quality of its data submissions and the effectiveness of its model risk management practices. Where shortcomings and deficiencies are identified, the PRA may apply adjustments to specific stress results or set a higher PRA buffer to gain more comfort in a firm's stress results. Enhanced supervision may also be considered in instances of serious or persistent failings.

²² 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 institution (G-SII) buffer, after accounting for the effect of risks that net off on consolidation.

²³ 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.

²⁴ This would include the capital conservation buffer, the countercyclical capital buffer and systemic buffers, if any.

New entrants and expanding smaller banks

9.45 The PRA will continue to apply a more flexible approach to new entrants and expanding smaller banks when setting the PRA buffer. This is set out in the July 2014 FCA and PRA publication 'A review of requirements for firms entering into or firms expanding in the banking sector: one year on',²⁵ RMG is reviewed as part of the authorisation process. There is no presumption of RMG deficiencies simply because the management team and board are new. The PRA will exercise its supervisory judgement to apply an RMG scalar or other capital add-on as deemed necessary on a case-by-case basis.

Reporting

9.46 The scope and intensity of the PRA's assessment is proportionate to the nature, scale, size, and complexity of the firms and is reflected in the granularity of the stress test data firms are required to submit. The Stress Test Data Framework (STDF) contains the data templates for the larger UK firms participating in the Bank's annual stress test.

9.47 All other firms with total assets equal to or greater than £5 billion, at the relevant level of consolidation used as the basis of their ICAAP, must report the data in the stress testing Pillar 2 data item (PRA111) in accordance with Reporting Pillar 2, 2.9. Firms are required to submit the data with their ICAAP submissions. Firms with total assets less than £5 billion may be requested by supervisors to complete PRA111 on a case-by-case basis. The information in PRA111 includes information on firms' base and stress scenario projections used in the ICAAP. PRA111 is aligned to the STDF used in the Bank's annual stress test with reduced granularity.

²⁵ See <https://www.fca.org.uk/publication/thematic-reviews/barriers-to-entry-review-one-year-on.pdf> 2014.pdf.

Appendix 2: Draft amendments to Supervisory Statement (SS) 31/15 ‘The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)’

This appendix outlines proposed amendments to SS31/15. Underlining indicates new text and striking through indicates deleted text. Please note that footnote references will be updated when the final policy is published.

...

2 Expectations of firms undertaking an ICAAP

...

IRRBB

2.7 All firms must have appropriate systems and processes, proportionate to the nature, scale and complexity of their business, to evaluate and manage IRRBB.

2.8 The systems and processes should allow the firm to:

- measure the exposure and sensitivity of its activities, if material, to re-pricing risk, yield curve risk, basis risk and risks arising from embedded optionality (eg pipeline risk and prepayment risk) as well as changes in assumptions (eg those relating to customer behaviour);
- consider whether a purely static analysis of the impact on its current portfolio of a given shock or shocks should be supplemented by a more dynamic simulation approach;
- model scenarios in which different interest rate paths are computed and in which some of the assumptions (eg about behaviour, contribution to risk and balance sheet size and composition) are themselves functions of interest rate levels; and
- measure the exposure and sensitivity of its ~~available-for-sale and~~ fair value exposures to changes in value resulting from yield curve and basis risk.

...

3 Stress testing, scenario analysis and capital planning

...

3.16 As part of its Annual Stress Testing framework, the Bank of England publishes a common stress scenarios aimed at assessing the UK banking system’s capital adequacy. This scenario is run concurrently across a number of participating firms, on an annual basis.

...

3.23 In making the estimate required by Internal Capital Adequacy Assessment 12.3, a firm should project both its capital resources and its required capital resources over a time horizon of three to five years, taking account of its business plan and the impact of relevant adverse scenarios. The firm should consider both the capital resources required to meet its capital

requirements under the CRR and the capital resources needed to meet the overall financial adequacy rule. The PRA's approach to projecting the Pillar 2A component of capital requirements is laid out in Chapter 9 in PRA Statement of Policy 'The PRA's methodologies for setting Pillar 2 capital'.¹ The PRA considers this approach to be appropriate for most firms. The firm should make all these projections in a manner consistent with its risk management processes and systems as set out in Internal Capital Adequacy Assessment 3.1.

...

4 Reverse stress testing

...

4.5 In carrying out the stress tests and scenario analyses required by rule 15.2 of the Internal Capital Adequacy Assessment Part of the PRA Rulebook a firm should at least take into account each of the sources of risk identified in accordance with Internal Capital Adequacy Assessment 3.1. ~~GENPRU 1.2.30R(2).~~

...

4.7 In carrying out its reverse stress testing, a firm ~~should~~ could consider scenarios in which the failure of one or more of its major counterparties or a significant market disruption arising from the failure of a major market participant, whether or not combined, would cause the firm's business to fail. For an RFB, this supervisory statement should be read in conjunction with SS8/16². SS8/16 sets out the PRA's expectation that an RFB sub-group should consider the failure of group entities that are not members of the RFB sub-group as part of reverse stress testing.

...

5 The SREP

...

5.12B Following this, the PRA will calculate the level of capital that is necessary, in addition to the capital the firm must hold to comply with the CRR (Pillar 1), to capture risks to which the firm is or might be exposed. This may lead to the PRA adjusting the firm's Pillar 2A add-ons, as assessed in accordance with the PRA's own methodologies, downward, taking into consideration how firms' capital relates to the IRB benchmarks considered as part of the peer review. The comparison to the benchmarks is not mechanistic and will depend on the extent to which it reflects firm-specific risk profiles, considering for example differences in Pillar 2A credit concentration risk add-ons between firms using the SA and IRB models.

...

5.14 Following the SREP, including both a review of the ICAAP and any further interactions with the firm, the PRA will normally set the firm's Pillar 2A capital requirement on an individual

¹ Available at <https://www.bankofengland.co.uk/prudential-regulation/publication/2015/the-pras-methodologies-for-setting-pillar-2-capital>.

² 'Ring-fenced bodies', November 2017: <https://www.bankofengland.co.uk/prudential-regulation/publication/2016/ring-fenced-bodies-ss>.

basis, for the amount and quality of capital that the PRA considers the firm should hold, in addition to the capital it must hold to comply with the CRR (Pillar 1 capital) to meet the overall financial adequacy rule in Internal Capital Adequacy Assessment 2.1. The PRA will additionally set Pillar 2A capital requirements for firms which must comply with the overall financial adequacy rule in Internal Capital Adequacy Assessment 2.1 on a consolidated basis and, where groups contain an RFB sub-group, on a sub-consolidated basis.

...

5.22 Where the PRA assesses a firm's risk management and governance (RM&G) to be significantly weak, it may also set the PRA buffer to ~~include an amount of capital to~~ cover the risks posed by those weaknesses until they are addressed. This will generally be calibrated in the form of a scalar applied to the amount of CET1 required to meet the firm's TCR. ~~Depending on the severity of the weaknesses identified, the scalar could range from 10% to 40%. The scalar could be to up to 40% of the total CET1 TCR (variable).~~ If the PRA sets the PRA buffer to cover the risk posed by significant weaknesses in risk management and/or governance or applies a suspended scalar, the PRA ~~it~~ will identify those weaknesses to the firm and expect the firm to address those weaknesses within an appropriate timeframe. Once the identified weaknesses have been remedied, the PRA will remove the scalar. If new weaknesses emerge that are not adequately addressed by the scalar or if remedial action taken by the firm has led to its removal a new scalar may be applied.

...

~~9.48 Transitional arrangements~~

~~5.26 All firms are expected to hold the PRA buffer entirely in CET1 capital from 1 January 2019. [Deleted.]~~

~~5.27 Firms are expected to meet their PRA buffer in increasing proportions of CET1 from January 2016 to January 2019: [Deleted.]~~

- ~~• at least 25% by January 2016;~~
- ~~• 50% by January 2017;~~
- ~~• 75% by January 2018; and~~
- ~~• 100% by January 2019.~~

~~5.28 During the transitional period, firms may meet the remaining portion of their PRA buffer with any form of CRR-compliant regulatory capital unless the PRA decides that in the particular circumstances of an individual firm it should hold higher quality capital to meet the PRA buffer. [Deleted.]~~

~~5.29 Some firms have been set a Core Capital Planning Buffer in the form of CET1 capital. The PRA expects these firms to meet their PRA buffer entirely in CET1 capital from 1 January 2016. [Deleted.]~~

~~5.30 The PRA will continue to apply a more flexible approach to new entrants and expanding banks when setting the PRA buffer, as set out for the CPB in the Bank of England and Financial~~

Conduct Authority (FCA) publication 'A review of requirements for firms entering into or expanding in the banking sector: one year on'. [Deleted.]

...

5.33 Use of the PRA buffer is not itself a breach of capital requirements or TCs. ~~However, where a firm has a PRA buffer in place, it should only use that buffer to absorb losses or meet increased capital requirements if certain adverse circumstances materialise. These should be circumstances beyond the firm's normal and direct control, whether relating to a deteriorating external environment or periods of stress such as macroeconomic downturns or financial/market shocks, or firm-specific circumstances. The PRA expects firms to use their PRA buffer (and indeed other capital buffers) in times of stress. Use of buffers (including both the combined buffer and PRA buffer) are what firms and the PRA model as part of their stress tests. The PRA does not expect or require firms to finance themselves with more capital than the total of their regulatory requirements and buffers. However, where a firm has a PRA buffer in place, it should not use that buffer in the normal course of business or enter into it as part of its base business plan.~~

5.34 Consistent with Fundamental Rule 7, a firm should notify the PRA as early as possible where it has identified that it would need to use its PRA buffer (even if the firm has not accepted the PRA's assessment of the amount of capital required for the PRA buffer). The firm's notification should state as a minimum:

- what adverse circumstances are likely to ~~force~~ lead the firm to draw down its PRA buffer;
- how the PRA buffer will be used up in line with the firm's capital planning projections; and
- ~~what the plan and timeframe is in place for the eventual~~ to restore ~~ation of~~ the PRA buffer.

5.35 A firm which does not meet its PRA buffer can expect enhanced supervisory action, and should prepare a capital restoration plan.³ If the PRA is satisfied with the rationale presented, the PRA will be content for firms to rebuild their buffers over a reasonable period of time. In exercising its judgement on what constitutes a reasonable time to rebuild the PRA buffer (and potentially other capital buffers) and other potential supervisory action, the PRA will take into account how far the firm has run into its buffers, the expected duration of the stress, the drivers of that stress, the context of that stress (whether firm-specific or systemic) and macroeconomic and financial conditions. If the PRA is not satisfied with the capital restoration plan or with the firm's reasons for using the buffer it may consider using its powers under section 55M of FSMA to require the firm to raise sufficient capital to meet the buffer within an appropriate timeframe.

...

³ Where a firm does not meet its combined buffer it must do so as a part of a capital conservation plan including the information in Capital Buffers 4.5.

Appendix 3: Draft amendments to SS6/14 ‘Implementing CRD IV: Capital buffers’

This appendix outlines proposed amendments to SS6/14. Underlining indicates new text and striking through indicates deleted text. Please note that footnote references will be updated when the final policy is published.

...

3 Capital conservation measures

3.1 Firms may use their combined buffer as required in times of stress, but should not use it in the normal course of business or propose to enter it as part of their base business plan. As set out in the PRA’s capital buffers rules, firms that do not meet their combined buffer shall face restrictions on their distributions, and be subject to a maximum distributable amount (MDA).¹ The MDA must be calculated as the product of 60%, 40%, 20% or 0% (depending on which quartile of its combined buffer the firm is in)² and the sum of interim and year-end profits (as defined in Capital Buffers 4.3(5)) generated since the most recent decision on:

- (i) the distribution of profits;
- (ii) making a distribution in connection with Common Equity Tier 1 capital;
- (iii) creating an obligation to pay variable remuneration or discretionary pension benefits or pay variable remuneration if the obligation to pay was created at a time when the institution failed to meet the combined buffer requirements; or
- (iv) making payments on additional Tier 1 instruments.

...

3.3 Where a firm does not meet its combined buffer it must prepare a capital conservation plan including the information in Capital Buffers 4.5. The PRA will assess the plan and approve it only if the PRA considers that the plan if implemented would be reasonably likely to conserve or raise sufficient capital to enable the firm to meet its combined buffer within a period which the PRA considers appropriate. In exercising its judgement on what is appropriate the PRA will take into account how far the firm has run into its buffers and the expected duration of the stress. It will also consider the drivers and context of that stress (whether firm specific or systemic) and macroeconomic and financial conditions. Consistent with the PRA’s Principle 11,³ a firm should notify the PRA as early as possible in advance where it has identified a material risk to its ability to meet the combined buffer according to the capital conservation plan and timeframe approved by the PRA. The firm’s notification should include as minimum:

- (a) the MDA;

¹ Firms that do meet their combined buffer cannot make a distribution that will cause them to stop meeting it.

² Where firms are in the first quartile of their combined buffer (when they meet between 75% and 100% of it), 60% of such profits can be distributed. In the second quartile, 40% can be distributed; in the third quartile, 20%; and in the fourth quartile, 0%.

³ Or incoming Fundamental Rule 7 in the PRA Rulebook.

- (b) if the firm has given a notification under Capital Buffers 4.3(9), an update to that notification containing the information in Capital Buffers 4.3(9); and
- (c) an updated capital conservation plan as in Capital Buffers 4.