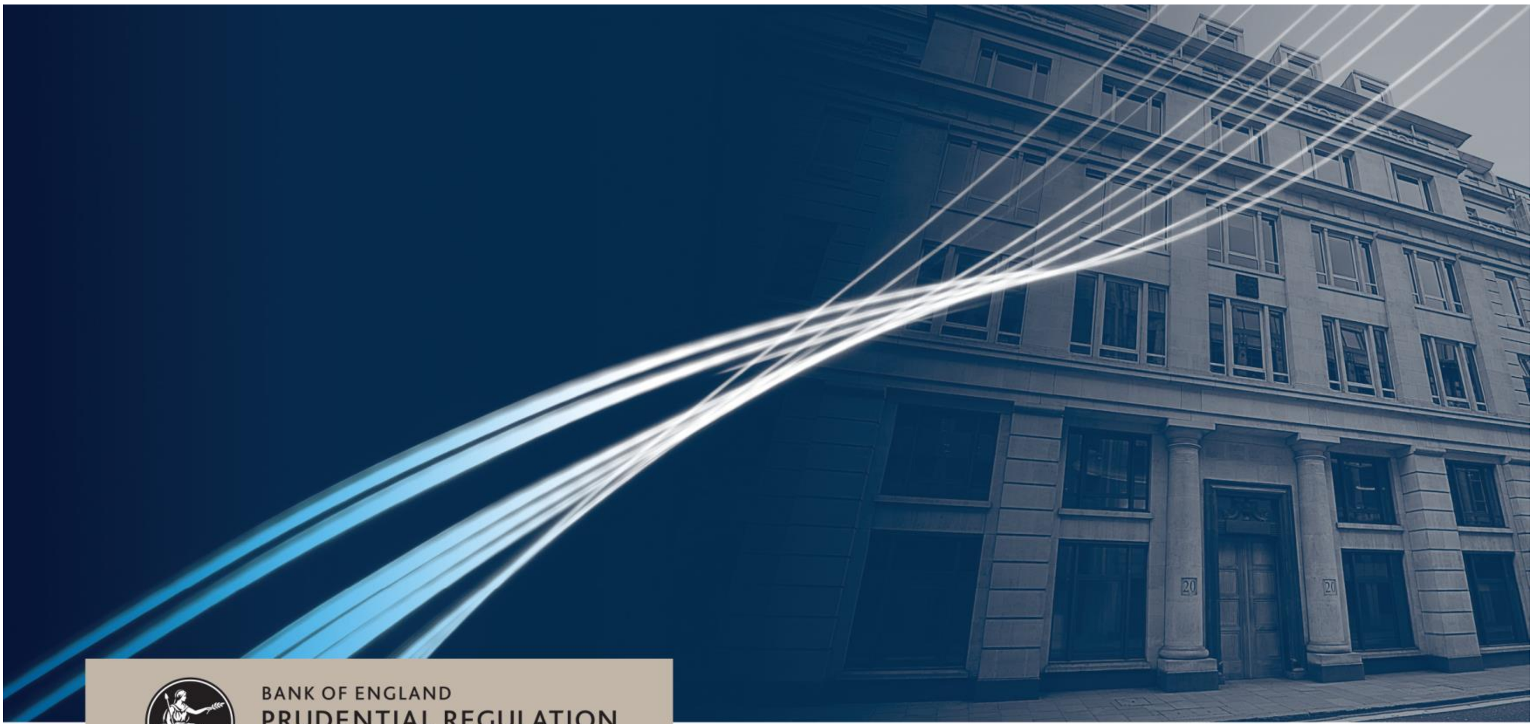

BANK OF ENGLAND
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Consultation Paper | CP17/20

Capital Requirements Directive V (CRD V): Further implementation

October 2020

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PRUDENTIAL REGULATION AUTHORITY

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Responses are requested by Tuesday 17 November 2020.

In light of current measures to help prevent the spread of COVID-19, please address any comments or enquiries by email to: CP17_20@bankofengland.co.uk.

Alternatively, please address any comments or enquiries to:
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Contents

1 Overview

1.1 This Consultation Paper (CP) sets out proposed changes to the Prudential Regulation Authority's (PRA) rules, supervisory statements (SS) and statements of policy (SoP) to implement elements of the Capital Requirements Directive V (CRD V).[1] It also proposes to update aspects of the UK regulatory framework as a result of amendments to the Capital Requirements Regulation (CRR, as amended in CRR II),[2] which apply during the European Union (EU) Exit Transition Period (transition period). This CP is relevant to banks, building societies, PRA-designated investment firms (firms), UK financial holding companies (FHCs), and UK mixed financial holding companies (MFHCs) of certain PRA-authorised firms.

1.2 This CP should be read in conjunction with CP12/20, which sets out the PRA's proposed approach to implementing other elements of CRD V, and HM Treasury's (HMT) approach to implementing aspects of CRD V and CRR II that require legislative changes in order to implement them in the UK. HMT's approach is being legislated for through The Financial Holding Companies (Approval etc.) and Capital Requirements (Capital Buffers and Macro-prudential Measures) (Amendment) (EU Exit) Regulations 2020, referred to here as 'the SI'.[3] [4]

Background

1.3 In May 2019, the EU published legislation[5] to implement, within the EU, some of the remaining Basel III prudential reforms agreed by the Basel Committee on Banking Supervision (BCBS). CRD V and CRR II amend CRD IV and CRR respectively.

1.4 CRR II applies directly in the EU. Some amendments apply from Monday 28 December 2020, so will become a specific type of UK law known as 'retained EU law', through the operation of the EU (Withdrawal) Act 2018 at the end of the transition period. The process of retaining and amending EU law so that it is operable in the UK after the end of the transition period is known as 'Nationalising the Acquis' or 'onshoring'.

1.5 CRD V is required to be transposed by Monday 28 December 2020. Most of CRD V's requirements apply from Tuesday 29 December 2020. UK Regulations and regulator rules implementing EU Directives are also 'retained EU law', and will be amended as necessary at the end of the transition period.

1.6 The PRA proposes to implement certain CRD V requirements which apply to firms during the transition period. The PRA proposes not to implement requirements of CRD V with which firms do not need to comply until after the end of the transition period. In particular, the PRA proposes not to implement the requirements related to interest rate risk in the non-trading book (which, for the purposes of this CP, will be referred to as interest rate risk in the banking book (IRRBB)).[6] The PRA instead proposes to implement the BCBS IRRBB standards directly in the UK regulatory framework from the end of the transition period.

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1 Directive (EU) 2019/878.
2 Regulation (EU) 2019/876.
3 In CP12/20 'Capital Requirements Directive V (CRD V)', the PRA set out its proposals in relation to: Pillar 2 supervisory requirements and guidance, remuneration policy, the new requirement for intermediate parent undertakings (IPUs), governance requirements, and reporting requirements: https://www.bankofengland.co.uk/prudential-regulation/publication/2020/capital-requirements-directive-v.
4 The Financial Holding Companies (Approval etc.) and Capital Requirements (Capital Buffers and Macro-prudential Measures) (Amendment) (EU Exit) Regulations 2020: https://www.legislation.gov.uk/ukdsi/2020/9780348213621.
5 CRD V and CRR II.
6 This aligns with HMT Treasury's proposed approach in, 'Transposition of the Bank Recovery and Resolution Directive II: consultation', June 2020: https://www.gov.uk/government/consultations/consultation-on-the-transposition-of-the-bank-recovery-and-resolution-directive-ii

Objectives of CRD V and CRR II

1.7 The financial crisis highlighted problems in banks' risk management and in the regulatory framework. In 2013, CRD IV and CRR – the EU legislation that implemented Basel III – sought to address many of those problems, such as the quantity and quality of banks' capital and liquidity resources. CRD V introduces further measures, implementing Basel III's enhanced Pillar 2 approach to the management and control of IRRBB. CRD V and CRR II also introduce a number of EU-specific measures designed to further harmonise micro and macroprudential supervision, and to introduce greater proportionality in prudential requirements.

1.8 The CRD V measures covered by this CP include:[7]

- a new requirement for the approval and supervision of certain holding companies;
- measures to enhance supervisory requirements to measure, monitor, and control IRRBB;
- measures revising the framework for applying capital buffers;
- amendments to the definition of the maximum distributable amount (MDA) that constrains a firm's distributions when it uses its capital buffers; and
- clarifying the quality of capital required to meet Pillar 2 requirements.

1.9 The CRR measures comprise adjustments to:

- the process through which variable capital requirements may be applied to firms' real estate exposures (and the public authority responsible for applying them); and
- the methods that may be used for the purposes of prudential consolidation.

Structure of this CP

1.10 This CP has two parts. Part One sets out the proposals to implement the relevant elements of CRD V. Part Two sets out the proposals to update aspects of the UK regulatory framework as a result of amendments in CRR II.

Part One

Holding companies

1.11 Under CRD IV and CRR, an EU group's bank and investment firm subsidiaries are responsible for ensuring that prudential requirements are met on a consolidated basis.

1.12 CRD V defines a framework for the approval and consolidated supervision of certain holding companies. CRR II makes approved holding companies solely responsible for ensuring that their group meets consolidated prudential requirements. The SI legislates for a bespoke framework for approving and supervising holding companies.[8]

1.13 The PRA's proposals to implement a process to apply for holding company approval, or exemption from approval, are set out in Chapter 2.

7 The CRD V measures covered by CP12/20 related to Pillar 2, remuneration, IPUs, governance, and third-country branch reporting.
8 Sections 192O to 192Z3 FSMA, inserted by Regulation 2 of The Financial Holding Companies (Approval etc.) and Capital Requirements (Capital Buffers and Macro-prudential Measures) (Amendment) (EU Exit) Regulations 2020.

Application of prudential requirements to approved holding companies

1.14 CRD V applies certain prudential requirements to approved holding companies on a consolidated basis.

1.15 The PRA's proposals to implement the requirements that apply to approved holding companies are set out in Chapter 3.

IRRBB

1.16 The current EU requirements on IRRBB under CRD IV's Pillar 2 require firms to implement systems to identify, evaluate, and manage potential changes in interest rates affecting their non-trading book activities. Those requirements are implemented through the Internal Capital Adequacy Assessment (ICAA) Part of the PRA Rulebook.[9] European Banking Authority (EBA) guidelines (GLs) apply requirements that implement, in the EU, many aspects of BCBS standards. Firms must make every effort to comply with those GLs during the transition period.

1.17 CRD V revises the supervisory framework for IRRBB and implements certain aspects of the BCBS standards in the EU, including introducing a new standardised framework, new outlier tests, and new interest rate shock scenarios.[10] The PRA proposes not to implement these aspects, as they do not apply to firms until after the end of the transition period.

1.18 Most of the BCBS standards on IRRBB are currently implemented in the EU through the EBA GLs. CRD V also implements certain aspects.

1.19 The PRA's proposals to implement the BCBS standards on IRRBB through a combination of PRA rules and supervisory expectations are set out in Chapter 4.

Capital buffers

1.20 CRD IV defines an other systemically important institutions (O-SII) buffer and a systemic risk buffer (SRB) that may be applied to firms to address certain systemic and macroprudential risks.[11] Together with the capital conservation buffer, the countercyclical capital buffer, and the global systemically important institutions (G-SII) buffer, the O-SII and SRB buffers make up CRD's 'combined buffer'.

1.21 CRD V clarifies the purpose and design of the O-SII buffer and the SRB, and amends the requirements for applying each of them. HMT has transposed these amendments through the SI.[12]

1.22 The PRA's proposals to implement the O-SII buffer in order to replace the role currently performed by the SRB are set out in Chapter 5. Chapter 5 also summarises the PRA's proposed approach to the revised SRB.

Maximum Distributable Amount (MDA)

1.23 CRD IV specifies automatic restrictions when a firm uses its combined buffer, which apply to its distributions on Common Equity Tier 1 (CET1) capital instruments, Additional Tier 1 (AT1) capital instruments, and variable remuneration.[13]

1.24 CRD V redefines the calculation of the MDA in a way that will improve buffer usability.

9 In particular, 3.1 and 9.
10 CRD V Articles 84, 98, and 104a.
11 CRD IV Articles 130 and 133.
12 Reg 14–20, SI.
13 CRD V Article 141.

1.25 The PRA's proposals for implementing CRD V's revision of the MDA definition are set out in Chapter 6. Chapter 6 also sets out the PRA's proposals to further amend the definition of the MDA after the end of the transition period.

Pillar 2

1.26 The current EU requirements under Pillar 2 of CRD IV do not specify the proportion of Pillar 2A requirements that must be met with CET1 capital.

1.27 In CP12/20, the PRA consulted on not amending its approach to the composition of capital for Pillar 2A. However, the PRA has identified the need for an amendment to align the PRA's approach to the proportion of CET1 capital required to meet Pillar 2A with that of CRD V. The PRA's proposals are set out in Chapter 7.

Governance

1.28 CRD IV did not include requirements for the reassessment of the fitness and propriety of board members where there are reasonable grounds to suspect that money laundering or terrorist financing may occur, or if there is an increased risk thereof.

1.29 CRD V includes these requirements for board members, including non-executive directors. CRD V also introduces changes to governance requirements that affect board members of holding companies. These amendments align the EU governance framework with CRR II and CRD V's new requirement for approved holding companies to be responsible for ensuring that groups meet their consolidated prudential requirements.

1.30 The PRA's proposals for implementing these amendments are set out in Chapter 8.

Part Two

CRR II: Variable risk weights for real estate exposures

1.31 CRR includes a micro- and macroprudential tool that allows a supervisor to increase the capital requirements applicable to certain real estate exposures. The PRA implemented this tool for commercial real estate exposures (CRE) on the Standardised Approach to credit risk (SA), applying a stricter condition than applies under CRR for access to a 50% risk weight.

1.32 CRR II requires EU Member States to designate the relevant micro or macroprudential authority that is responsible for using the tool. It introduces explicit requirements for co-ordination and information sharing when the tool is used, and redefines the conditions according to which the tool may be used.

1.33 The PRA's proposed approach to the use of CRR II's revised tool for CRE under SA is set out in Chapter 9.

CRR II: Methods of consolidation

1.34 CRR did not require the use of the equity method for certain holdings nor specify the conditions under which supervisors can allow or require a different method of prudential consolidation for them.

1.35 CRR II addresses this issue. It also clarifies the need to address the risk that a firm could decide to provide support to a subsidiary or undertaking in which it holds a participation of a certain type in the absence of an obligation to provide such support.

1.36 The PRA's proposals for implementing the new CRR II requirements are set out in Chapter 10.

Implementation

Application of EU law during the transition period

1.37 Some of the measures in CRR II, and the UK transposition of CRD V, come into effect on Monday 28 or Tuesday 29 December 2020. The version of the CRR which applies in the UK at 11pm on Thursday 31 December 2020 will become 'retained EU law' through the operation of the EU (Withdrawal) Act 2018.

CRR II and CRD V

1.38 CRR, as amended by CRR II, is the 'single rulebook'. It includes provisions relating to variable capital requirements for real estate exposures, and requires approved holding companies to become responsible for ensuring that consolidated prudential requirements are met. CRD, as amended by CRD V, contains, in particular, provisions concerning capital buffers, Pillar 2 and the capital stack, MDA, IRRBB, and the approval and supervision of certain EU holding companies.

CRD V

1.39 CRD is not directly applicable and must be transposed into UK law. A brief explanation of the PRA's approach to transposition, and the text of the proposed draft rules, is included in this CP.

CRR II

1.40 CRR II amendments to CRR are directly applicable without the need for implementation by a national legal instrument. However, the provisions relating to variable capital requirements for real estate exposures would require HMT to designate the PRA or the Financial Policy Committee (FPC) as responsible for using this tool. The SI designates the PRA as responsible.[14]

1.41 The PRA may give effect to CRR discretions and derogations through specific rules. A brief explanation of the PRA's proposed use of such discretions and derogations, along with draft rules, is included in this CP.

EBA technical standards, guidelines, and Q&As

1.42 CRD V provides for technical standards to be drafted by the EBA. Such standards are subject to adoption by the European Commission before they come into force as directly applicable regulations. If applicable prior to 11pm on Thursday 31 December 2020, these standards will be onshored at the end of the transition period and will become known as UK technical standards.

1.43 The EBA is also mandated to draft GLs in specified areas. EU GLs do not form part of 'retained EU law'. After the end of the transition period, GLs with which the UK has notified compliance and which remain relevant should be read in conjunction with the Bank and PRA SoP on EU Guidelines and Recommendations.[15]

1.44 Any additional relevant technical standards or GLs that become applicable before the end of the transition period may cause the PRA to consider whether it needs to adjust elements included in this consultation. Where particularly relevant, reference is made to standards and GLs in specific chapters of this CP. All references to technical standards are to the UK version applicable after the end of the transition period unless otherwise stated.

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14 Amendment of the Capital Requirements Regulations 2013, (Reg 4 SI).
15 April 2019: https://www.bankofengland.co.uk/paper/2019/interpretation-of-eu-guidelines-and-recommendations-boe-and-pra-approach-sop.

1.45 The EBA also applies a Q&A tool to facilitate a common understanding of provisions related to CRD V. The PRA notes that the Q&As have no binding force in EU law, and are not subject to 'comply or explain' requirements.

Co-ordination with other UK bodies

1.46 The PRA has consulted with the Financial Conduct Authority (FCA) on CRD V implementation where it affects FCA objectives. Responses to this CP will be shared with the FCA where they affect FCA objectives.

1.47 Some provisions in CRD V must be implemented by HMT or other UK bodies. For example, CRD V provisions on capital buffers and holding company approval and supervision place obligations on the PRA and/or FPC, and have therefore been transposed by HMT. Furthermore, HMT has designated which authorities will be responsible for the application of variable capital requirements for real estate under CRR II and for the SRB and O-SII buffer under CRD V.

Application after the end of the transition period

1.48 The proposals set out in this CP have been designed in the context of the UK's withdrawal from the EU and entry into the transition period, during which time the UK remains subject to EU law. The PRA will keep the policy under review to assess whether any changes would be required due to changes in the UK regulatory framework at the end of the transition period, including those arising once any new arrangements with the EU take effect. Except where otherwise stated, the proposals set out in this CP would continue to apply after the end of the transition period.

1.49 The PRA has assessed that the proposals would need to be amended under the EU (Withdrawal) Act 2018 (EUWA 2018), to fix deficiencies in the onshored version of the Rulebook on Thursday 31 December 2020. A second version of the proposed rules, which includes the relevant amendments under EUWA 2018, is set out in Appendix 2. These proposed amendments to rules must be read in conjunction with the proposed amendments set out in Appendix 4 of the PRA's CP13/20.[16] With the exception of draft SS6/14, SS31/15, and SS20/15, the draft SSs and SoPs attached to this CP should be read in conjunction with SS1/19 'Non-binding PRA materials: The PRA's approach after the UK's withdrawal from the EU'.[17] In general, the PRA does not intend to make line-by-line amendments to non-binding PRA materials that are applicable ahead of the UK's withdrawal from the EU. However, from the end of the transition period, firms should read and interpret these materials in light of the UK's withdrawal from the EU. In particular firms should take into account the amendments that have been made to related legislation under EUWA 2018, as outlined in SS1/19. This includes changes made under EUWA 2018 to primary 'retained EU law', as well as to the PRA Rulebook and Binding Technical Standards.

1.50 After the end of the transition period, EU GLs referred to in these proposals should be read in conjunction with the SoP 'Interpretation of EU Guidelines: Bank of England and PRA approach after the UK's withdrawal from the EU'.[18] This sets out that the Bank of England and PRA expect firms and financial market infrastructures to continue to make every effort to comply with EU Recommendations and GLs, with which the UK has notified its intent to comply, to the extent that they remain relevant when the UK leaves the EU.

16 September 2020: https://www.bankofengland.co.uk/prudential-regulation/publication/2020/uk-withdrawal-from-the-eu-changes-before-the-end-of-the-transition-period.
17 April 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.
18 April 2019: https://www.bankofengland.co.uk/paper/2019/interpretation-of-eu-guidelines-and-recommendations-boe-and-pra-approach-sop.

1.51 The first set of amendments to SS6/14 will apply to firms from Tuesday 29 December 2020. At the end of the transition period, there will be a further set of amendments to SS6/14.

1.52 The amendments to SS31/15 and SS20/15 are due to apply to firms only after the end of the transition period. Therefore, they reflect the fact that EU law will not be applicable at that point. All references in the revised SS31/15 and SS20/15 to Regulations and Binding Technical Standards are to the onshored versions, which are the versions that will apply in UK law after the end of the transition period and will include the relevant amendments under EUWA 2018.

Responses and next steps

1.53 This consultation closes on Tuesday 17 November 2020. Please note that this is a shortened consultation period, which is necessary to meet the transposition date for CRD V (Monday 28 December 2020).

1.54 The PRA invites feedback on the proposals set out in this consultation, and also on the specific questions included in Chapters 4 and 6. The PRA would also welcome firms' views on whether additional and material costs not identified in Chapter 11, including for holding companies, may arise as a result of the proposals. Please address any comments or enquiries to CP17_20@bankofengland.co.uk.

Part One

2 Holding companies

CRD Article 21a

2.1 CRD V introduces new requirements for certain types of parent financial holding company (FHC) or mixed financial holding company (MFHC) that substantively control their group to be subject to supervisory approval and consolidated supervision.[19] The approval conditions must be met at the point of approval and on a continuing basis thereafter. From Monday 28 December 2020, CRR II requires that an approved parent holding company becomes responsible for ensuring its group meets consolidated prudential requirements.[20] This CRR II requirement will apply directly to such firms during the transition period and will be onshored at the end of that period.

2.2 CRD V's holding company requirements are intended to strengthen prudential supervision by making FHCs and MFHCs subject to direct supervision to ensure compliance with consolidated or sub-consolidated prudential requirements. Effective consolidated supervision helps to ensure the safety and soundness of firms, in line with the PRA's objectives.

2.3 The SI transposes the new CRD V requirements on relevant FHCs and MFHCs.[21] It extends powers to the PRA to supervise, monitor, exercise discretions, impose additional requirements, and enforce against breaches of obligations in respect of holding companies. It also creates a bespoke approval regime for relevant holding companies, with scope for the PRA to supplement certain aspects. The proposals in this chapter are based on the SI.

2.4 The proposals in this chapter summarise the process the PRA would follow in evaluating applications for FHC or MFHC approval or exemption.

Proposals

Requirement to apply for supervisory approval

2.5 The SI requires the following holding companies to apply for supervisory approval:[22]

- parent FHCs and MFHCs in the UK; and
- other FHCs or MFHCs that are required to comply with CRD (UK law) or CRR on a sub-consolidated basis.

2.6 The PRA proposes to implement a process for reviewing applications for approval or exemption, in accordance with HMT's transposition of these CRD V requirements. Details are set out below.

Conditions for approval

2.7 The SI defines the conditions for approval.[23] They cover:

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19 CRD V Article 21a.
20 CRR II Article 11.
21 Part 12 B (Approval of certain holding companies) FSMA, (Reg 2, SI).
22 s.192O FSMA, (Reg 2, SI).
23 s.192R FSMA (Reg 2, SI).

- the adequacy of the internal organisation of the group to ensure compliance with the prudential requirements of CRD and CRR on a consolidated or sub-consolidated basis;
- the effect of the structure of the consolidated or sub-consolidated group on the supervisor's ability to supervise it effectively; and
- CRD requirements regarding qualifying holdings and the fitness and propriety of members of the management body of the FHC or MFHC.[24]

2.8 The PRA will assess an applicant's compliance with the conditions defined in the SI.

Exemption from approval

2.9 The SI specifies that FHCs and MFHCs do not require approval where specific conditions are met.[25] The conditions seek to define those FHCs and MFHCs that do not have effective control over the group or its bank, investment firm, or financial institution subsidiaries.

2.10 The PRA will assess compliance with the criteria for exemption.

Information required

2.11 The SI specifies the types of information that holding companies must provide when applying for approval.[26] The SI requires the information to cover the structure and internal organisation of the group, persons controlling the group, compliance with certain conditions applicable to shareholders, and any other information the supervisor requires to assess compliance with the approval conditions.

2.12 The PRA has included draft information requirements in Appendix 5 relating to the approval and exemption requirements. In addition to the application form, which will be published on the PRA website in due course, this will provide a consistent basis for the submission and review of applications. In designing the requirements, the PRA has sought to ensure it obtains sufficient information to assess compliance with the approval requirements efficiently, while minimising the compliance cost of completing the application. It also explains PRA expectations of the types of information, and level of detail, required.

Approval process

2.13 The SI requires relevant FHCs and MFHCs to apply for approval by Monday 28 June 2021.[27]

2.14 The PRA expects to receive a significant number of applications for approval and exemption from approval. In order to manage the application process efficiently and effectively, the PRA proposes that holding companies submit their formal applications in the period Monday 3 May to Monday 31 May 2021. Prior to May 2021, the PRA intends to engage with potential applicants in order to ensure they understand the PRA's expectations of the process and the information required. The PRA will consider whether it will be necessary to publish further clarification of the approval process in light of the responses to this consultation.

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24 CRD V Articles 14 and 121.
25 s.FSMA 192P (Reg 2 SI).
26 s.FSMA 192Q, (Reg 2 SI).
27 The Financial Holding Companies (Approval etc.) and Capital Requirements (Capital Buffers and Macro-prudential Measures) (Amendment) (EU Exit) Regulations 2020, Part 2, Amendment of the Capital Requirements Regulations 2013, 5.

Intermediate holding companies of ring-fenced bodies

2.15 The PRA intends to consider using its power of direction over qualifying parent undertakings to apply prudential requirements to intermediate holding companies of groups which are required to meet CRR/CRD requirements on a sub-consolidated basis.[28] [29] As a result, they would be required to apply for approval.

2.16 Ensuring the PRA is able to address risks at the intermediate holding company level arising from a subgroup would help the PRA ensure the safety and soundness of the firms within that subgroup. It would achieve this by applying prudential requirements on a sub-consolidated basis to the relevant approved holding companies, and by aligning responsibility for meeting prudential requirements more closely with the level at which decisions are made.

Designation

2.17 From Monday 28 December 2020, CRR II makes approved holding companies responsible for ensuring that consolidated prudential requirements are met.[30] This aspect of CRR II will be onshored on Thursday 31 December 2020.

2.18 The SI allows the PRA to designate which PRA-authorised subsidiaries within a group are the entities that should be responsible for ensuring consolidated prudential requirements are met, from Thursday 28 December 2020 until the date on which the application for approval of a group's parent holding company has been approved or rejected.[31] This will ensure that PRA-authorised subsidiaries within the group remain responsible for ensuring that consolidated prudential requirements are met during the interim period.

2.19 In the event the PRA determines the conditions for holding company approval not to be met, the PRA proposes to designate, on a temporary basis, another FHC, MFHC, or PRA-authorised firm within the group as responsible for ensuring the compliance of a group or sub-consolidated group with the relevant consolidated or sub-consolidated prudential requirements.

Supervisory monitoring of compliance

2.20 The SI requires the PRA to monitor compliance with the conditions for approval, and exemption from approval, on a continuing basis.[32] The PRA proposes to consider the information required to facilitate its ongoing monitoring in due course, once it has finalised the information requirements for approval. The PRA is considering what combination of regular information, attestation, and notification of material changes, may be appropriate, drawing where possible on its existing supervisory interactions with the groups in question. The PRA would welcome stakeholders' views on how best to ensure that the PRA obtains sufficient information for monitoring purposes, while also minimising the costs of compliance.

Supervisory measures

2.21 The SI requires the PRA to apply supervisory measures to a holding company that does not meet, or ceases to meet, the conditions for approval. It defines a non-exhaustive list of measures the PRA might take.[33] The PRA intends to consider, on a case-by-case basis, the nature of the

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28 s.192C FSMA.
29 Currently, the PRA uses the discretion under CRR Article 11 to apply these requirements.
30 CRR Article 11(2)
31 Amendment of the Capital Requirements Regulations 2013 (Reg 5, SI).
32 s.192S FSMA, (Reg 2, SI).
33 s.192T (Reg 2 SI).

supervisory measures that are necessary and appropriate in the event that the conditions for approval are not met or cease to be met.

Consequential amendments

2.22 The PRA proposes to consult in due course on the detailed consequential amendments required to the PRA Rulebook and supervisory statements to apply prudential requirements to approved holding companies on a consolidated or sub-consolidated basis, as appropriate. This will include the treatment of waivers, permissions, and requirements applied at consolidated level, and any consequential amendments needed to the PRA's approach to consolidated supervision.

Fees

2.23 The PRA intends to set out its proposed approach to application and periodic fees for approved holding companies in the forthcoming fees policy consultation.

3 Application of prudential requirements to approved holding companies

CRD 108, 109, 110, 129, 130, 131, and 133

3.1 This chapter sets out the PRA's proposed implementation of consequential changes required to the PRA Rulebook in order to apply certain prudential requirements to approved holding companies on a consolidated or sub-consolidated basis.

3.2 CRD V's provisions applying prudential requirements to approved holding companies on a consolidated basis are intended to ensure the prudence and consistency of a consolidated group's approach to governance, risk management, and systems and controls.

3.3 The proposals in this chapter would make amendments to the following Parts of the PRA Rulebook:

- General Organisational Requirements (GOR);
- Skills, Knowledge and Expertise;
- Risk Control;
- Remuneration;
- Individual Capital Adequacy Assessment (ICAA);
- Individual Liquidity Adequacy Assessment (ILAA);
- Group Risk Systems; and
- Capital Buffers.

Proposals

3.4 CRD IV requires supervisors to ensure that firms meet prudential requirements at consolidated level in the following areas:

- internal capital to cover the risks to which a firm is or may be exposed;[34]
- internal governance and recovery and resolution plans;[35]
- oversight of remuneration policies;[36]
- review, assessment, and approval of risks;[37]
- internal risk assessment and use of external ratings;[38]
- supervisory benchmarking of internal models;[39]

[34] CRD Articles 108 and 73.
[35] CRD Article 74.
[36] CRD Article 75.
[37] CRD Article 76.
[38] CRD Article 77.

- the measurement, management, and control of:
    - credit and counterparty risk;[40]
    - residual risk from the use of credit risk mitigation techniques;[41]
    - concentration risk;[42]
    - risk from the use of securitisation transactions;[43]
    - market risk;[44]
    - IRRBB;[45]
    - operational risk;[46]
    - liquidity risk;[47] and
    - the risk of excessive leverage;[48]
- governance arrangements;[49]
- disclosure of activities across countries and return on assets;[50]
- fitness and propriety of members of the management body;[51]
- remuneration;[52] and
- website on corporate governance and remuneration;[53]
- additional own funds requirements and guidance;[54] and
- capital buffers.[55]

3.5 Under CRR II and CRD V, approved holding companies become responsible for ensuring that prudential requirements are met at the appropriate level.[56] The PRA proposes to amend the relevant parts of the PRA Rulebook accordingly. Where these consolidated prudential requirements are currently implemented through firm-specific requirements under section 55M of the Financial

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39 CRD Article 78.
40 CRD Article 79.
41 CRD Article 80.
42 CRD Article 81.
43 CRD Article 82.
44 CRD Article 83.
45 CRD Article 94.
46 CRD Article 85.
47 CRD Article 86.
48 CRD Article 87.
49 CRD Article 88.
50 CRD Articles 89 and 90.
51 CRD Article 91.
52 CRD Articles 92 to 95.
53 CRD Article 96.
54 CRD Articles 104, 104a, 104b, and 110.
55 CRD Articles 129, 130, 131, and 133.
56 CRD V Article 3(3) and CRR II Article 11(2).

Services and Markets Act 2000 (FSMA), the PRA intends to consider using its power of direction over qualifying parent undertakings[57] to apply equivalent requirements to approved holding companies.

57 s.192C FSMA.

4 Interest rate risk in the banking book (IRRBB)

CRD Articles 84, 98, and 104a

4.1 This chapter sets out the PRA's proposed implementation of changes to Pillar 2 provisions relating to IRRBB.

4.2 IRRBB is the current or prospective risk to earnings and economic value arising from adverse movements in interest rates that affect interest rate sensitive instruments in the banking book. Requirements and supervisory expectations regarding IRRBB address a risk not covered by Pillar 1 standards, thereby advancing the safety and soundness of firms in line with the PRA's statutory objectives. As set out in Rule 3.1 of the ICAA Part of the PRA Rulebook, which covers Pillar 2, a firm must have in place sound, effective, and comprehensive strategies, processes, and systems to (among other things) assess and maintain on an ongoing basis the amounts, types, and distribution of financial resources, own funds, and internal capital that it considers adequate to cover the nature and level of the risks to which it is or might be exposed.

4.3 The proposals in this chapter would amend:

- the ICAA Part of the PRA Rulebook;
- SS31/15 'The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)'; and
- SS20/15 'Supervising building societies' treasury and lending activities'.

4.4 Owing to the large number of paragraphs that would be inserted into Chapter 2 of SS31/15, the PRA proposes to make formatting changes to that chapter by introducing sub-headings to improve readability.

Proposals

4.5 Most of the BCBS IRRBB standards are implemented in the EU through the EBA GLs on IRRBB,[58] and CRD V also implements certain aspects. The PRA proposes not to implement CRD V's requirements on IRRBB, as they do not need to be complied with by firms until after the transition period ends.[59] The PRA proposes instead to implement the BCBS IRRBB standards directly in the PRA regulatory framework, including those requirements that CRD V was due to implement from the end of the transition period.[60] The new standards would supplant the PRA's expectations regarding compliance with EBA GLs after the transition period, as set out in SS1/19.[61]

4.6 The PRA proposes to implement the BCBS IRRBB standards by: (i) specifying a number of components in Chapter 9 of the ICAA Part; and (ii) incorporating the remaining standards in SS31/15. This approach aims to strike an appropriate and proportionate balance between setting a small

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58 EBA/GL/2018/02 'Guidelines on the management of interest rate risk arising from non-trading book activities'.
59 This applies the approach to transposition of measures that apply after the end of the transition period, on which HMT consulted in its Transposition of the Bank Recovery and Resolution Directive II.
60 'Standards: Interest rate risk in the banking book'. April 2016: https://www.bis.org/bcbs/publ/d368.pdf.
61 At the end of the transition period, Guidelines and Recommendations issued by European Supervisory Authorities are not saved by the European Union (Withdrawal) Act 2018. HMT has stated it intends to delete the obligation to make every effort to comply with those Guidelines and Recommendations. The Bank of England and PRA published a joint Statement of Policy (SoP) on the approach to EU Guidelines and Recommendations after the UK's withdrawal from the EU. For GLs that are currently complied with in the UK, including the 2018 EBA guidelines on IRRBB, that SoP set an expectation that firms continue after the end of the transition period to comply with GLs, to the extent they are addressed directly to firms and remain relevant. April 2019: https://www.bankofengland.co.uk/paper/2019/interpretation-of-eu-guidelines-and-recommendations-boe-and-pra-approach-sop.

number of minimum requirements that lay the foundations of the revised standards, and providing further explanation of PRA's expectations of their implementation.

4.7 The PRA anticipates that firms' compliance with the currently applicable EBA GLs on IRRBB will help to ensure they are well positioned to meet the PRA's proposed requirements and expectations on IRRBB.

General requirements

4.8 The PRA proposes to update the general requirement section of ICAA Chapter 9 to implement the BCBS IRRBB standards by:

- clarifying that a firm's identification, evaluation, and management of IRRBB systems must cover the risk of changes impacting the economic value of a firm's non-trading activities and related earnings;
- setting a new, explicit requirement to monitor and assess credit spread risk from non-trading activities;
- introducing the BCBS outlier test, which compares the maximum change in a firm's economic value of equity (ΔEVE) with 15% of its Tier 1 capital, under specific interest rate shock scenarios; and
- specifying governance requirements for IRRBB risk appetite and risk management.

4.9 CRD V requirements do not need to be applied in the EU until Monday 28 June 2021. However, the EBA's GLs on IRRBB already apply requirements from BCBS standards to PRA-authorised firms, including the ΔEVE outlier test. The PRA proposes to apply the BCBS standards from the end of the transition period. As the majority of those standards apply already through EBA's GLs, the PRA's proposed approach should not represent a significant change in the substance of the IRRBB requirements that are currently applicable to PRA-authorised firms. However, the status of the applicable IRRBB requirements would change from an EBA GLs requirement, with which firms must make every effort to comply, to binding PRA rules or supervisory expectations. The PRA's proposed approach would ensure the consistent application of the BCBS IRRBB standards in the UK after the end of the transition period.

4.10 Although not already addressed by the EBA GLs on IRRBB, the PRA proposes to also apply rules and expectations on the BCBS standardised framework from the end of the transition period. The PRA considers that this would not impose any significant additional burden on firms, as the proposed PRA rules would give firms the option to implement the standardised framework. The PRA anticipates that in the event firms were directed to use the standardised framework, owing to deficient internal systems, doing so would be consistent with the PRA's approach to banking supervision.[62]

4.11 In order to ensure the effective implementation of the BCBS IRRBB standards, the PRA proposes to set supervisory expectations for IRRBB in SS31/15, covering IRRBB governance risk appetite, risk measurement, behavioural and modelling assumptions, data integrity, and model governance. This proposal will help to ensure that these aspects can be implemented effectively and proportionately given differences in the nature, scale, and complexity of different firms' activities.

62 October 2018: https://www.bankofengland.co.uk/prudential-regulation/publication/2018/pra-approach-documents-2018.

Interest rate risk shock scenarios

4.12 The PRA proposes to specify, in ICAA Chapter 9, six interest rate shock scenarios that firms must use when applying the outlier test.

Additional outlier tests

4.13 The BCBS IRRBB standards recognise that supervisors may choose to implement additional outlier tests. The PRA does not propose to implement such additional tests at this time. However, the PRA intends to consider whether one or more additional net interest income (NII) outlier tests should be specified in future. The PRA will further consider the need for, and benefits of, such additional tests in light of international developments and experience from applying the new IRRBB framework.[63]

Measurement of IRRBB

4.14 The BCBS IRRBB standards introduce a new standardised framework that supervisors could require firms to use, or that firms could choose to adopt. The standardised framework also prescribes a simple methodology for estimating prepayment on retail fixed rate loans, and early redemption on retail term deposits. PRA-authorised firms currently use internal systems to identify, evaluate, and manage IRRBB.

Internal systems

4.15 The PRA proposes to allow firms to continue to use internal systems to identify, evaluate, and manage IRRBB, provided those systems meet the requirements in the PRA Rulebook. The PRA also proposes to update SS31/15 to clarify that if the PRA assesses that a firm's internal systems are not adequate for those purposes, it would apply appropriate supervisory measures to remediate the shortcomings identified. That could include measures such as applying an additional own funds requirement under Pillar 2A, or directing firms to use the standardised framework.

Standardised framework

4.16 The PRA proposes to implement the BCBS standardised framework within ICAA Chapter 9. This will ensure that firms using the framework are subject to consistent standards. The PRA proposes to require firms that choose to use the standardised framework to pre-notify the PRA of their intention to use it, and of the particular parameters they propose to use.

4.17 The PRA also proposes to use the standardised framework as a potential fall back measure that it could direct firms to use in the event their internal systems were not adequate to identify, evaluate, and manage interest rate risk. The PRA is not proposing changes to the current supervisory approach for monitoring or reviewing IRRBB internal systems.

4.18 The standardised framework methodology prescribed in the BCBS IRRBB standards does not fully specify how future cash flows allocated to longer time buckets should be adjusted following prepayment (for fixed rate loans) or early redemption (for term deposits). In order to make the standardised framework operational, the PRA proposes to specify formulae in ICAA Chapter 9 for determining these adjusted future cash flows.

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63 CRD V requires EU firms to apply two additional outlier tests on net interest income (NII) from Monday 28 June 2021. Those tests are to be specified in EBA regulatory technical standards. On Friday 12 June 2020, the EBA requested that the CRD V technical standards on IRRBB be assigned a revised deadline for submission to the European Commission of March 2022: https://eba.europa.eu/sites/default/documents/files/document_library/About%20Us/Missions%20and%20tasks/Correspondence%20with%20EU%20institutions/2020/885560/2020%2006%2012%20Letter%20to%20Mr%20Berrigan%20re%20Request%20for%20new%20deadlines%20under%20the%20RRM_rev.pdf.

4.19 The BCBS IRRBB standardised framework sets a euro-denominated threshold. The PRA proposes to set this threshold in sterling in the PRA Rulebook. The PRA proposes to use the approach to currency conversion set out in CP12/20, which used the average of daily GBP/EUR spot exchange rates over a 12-month period prior to Friday 10 July 2020: £1 = €1.14.[64] With this average rate, the threshold for treating certain non-retail deposits as retail deposits would be set at £877,000 rather than €1 million.

Proportionality

4.20 The PRA considers firms' current use of internal systems to be proportionate, as the complexity and burden from using them tends to vary with a firm's nature, scale, and the complexity of its non-trading activities. The PRA also considers the BCBS IRRBB standardised framework to offer a prudent and proportionate alternative to the use of internal systems.

4.21 In view of firms' current use of internal systems, and the proportionate alternative of the standardised framework, the PRA does not propose, at this stage, to define a simpler version of the standardised framework that smaller and less complex firms might use. Nevertheless, the PRA recognises the potential benefits, for firms with minimal or less complex IRRBB, of a strong and simple alternative to internal systems and the standardised framework. Therefore, the PRA intends to further consider the merits of developing, in due course, a simplified version of the standardised framework.[65]

Review of outliers

4.22 The PRA proposes to update ICAA Chapter 9 to require firms to notify it without delay in the event that they breach the outlier test. Consistent with the BCBS standards, SS31/15 would be updated to clarify that the PRA intends to undertake a review of a firm that breaches the outlier test, to assess whether the firm has excessive IRRBB risk relative to its capital or earnings.

Supervisory action

4.23 The BCBS IRRBB standards require supervisors to apply specific supervisory measures where IRRBB is inadequately managed or excessive. The PRA proposes to implement this requirement by updating SS31/15 to clarify that if the PRA concludes that a firm's management of interest rate risk arising from non-trading book activities is inadequate, or that its IRRBB is excessive relative to its capital, earnings, or its general risk profile, then the PRA may require the firm to take one or more of the following actions within a specified time frame:[66]

- reduce its IRRBB exposures;
- hold additional capital;
- apply constraints on the internal risk parameters it uses; and
- improve its risk management and/or address deficiencies in the firm's models.

4.24 The PRA may apply other supervisory measures, as appropriate.

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64 September 2020: https://www.bankofengland.co.uk/prudential-regulation/publication/2020/capital-requirements-directive-v.

65 CRD V Article 84(1) and (4) introduce the concept of a simplified standardised methodology for IRRBB. CRD V Article 84(5) requires the EBA to specify that methodology in a regulatory technical standard. The draft technical standard is expected to be submitted to be submitted to the European Commission by March 2022: https://eba.europa.eu/sites/default/documents/files/document_library/About%20Us/Missions%20and%20tasks/Correspondence%20with%20EU%20institutions/2020/885560/2020%2006%2012%20Letter%20to%20Mr%20Berrigan%20re%20Request%20for%20new%20deadlines%20under%20the%20RRM_rev.pdf.

66 These actions reflect those set out in Principle 12 of the Basel standards.

Pillar 2A

4.25 A Pillar 2 capital methodology for IRRBB is not prescribed by BCBS standards, CRD IV or CRD V.

4.26 The PRA capitalises IRRBB under its Pillar 2A capital methodology.[67] [68] The PRA's approach requires firms to calculate the potential for changes in interest rates to reduce their economic value. For larger or more complex firms, the PRA applies a comprehensive approach, and smaller and less complex firms are subject to a standard approach. The PRA proposes not to amend its existing Pillar 2A capital methodology. The PRA will review the need for potential amendments to its approach to IRRBB within Pillar 2A in due course, in light of the experience of applying the new standards on IRRBB.

Supervising building societies' treasury and lending activities

4.27 The PRA proposes to update SS20/15 to remove the cross-reference to the EBA SREP process, and instead cross-refer to the PRA ICAA Rules and SS31/15.

Reporting

4.28 The PRA requires all firms to report on IRRBB in the form FSA017. FSA017 collects information on the interest rate gap.[69] It also allows the PRA to identify outlier firms based on the current test under CRD IV, but does not collect information based on the new BCBS ∆EVE outlier test.

4.29 The BCBS IRRBB standards require supervisors to collect enough information on IRRBB to allow them to assess banks' IRRBB exposures and to identify and monitor outlier firms (under the new outlier tests). The PRA proposes to update ICAA Chapter 9 to require firms to notify the PRA without delay if they exceed the outlier test thresholds. This proposal will ensure the PRA is able to identify and monitor outlier firms based on the new ∆EVE outlier test.

4.30 However, the proposed approach to reporting would not allow the PRA to monitor how close firms might be to breaching the outlier test. In light of further experience of applying the new framework, the PRA intends to consider revising FSA017 in future in order to ensure it continues to have sufficient information on firms' IRRBB.

4.31 CRR II includes new requirements on disclosures for IRRBB. The PRA intends to consult on its implementation of Basel III's new disclosure requirements for IRRBB in due course.

Questions

1. Is the proposed approach to implementing the BCBS standards through a combination of PRA rules and supervisory expectations sufficiently clear and proportionate?

2. Is it necessary to develop a simplified version of the standardised methodology?

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67 Chapter 7, February 2020: https://www.bankofengland.co.uk/prudential-regulation/publication/2015/the-pras-methodologies-for-setting-pillar-2-capital.

68 This is consistent with the approach to Pillar 2 Requirements (Pillar 2R) set out in CRD V Article 104a(2), which permits a supervisor to apply Pillar 2R to address IRRBB where a firm's management of IRRBB is inadequate or it is excessively exposed to IRRBB.

69 Neither CRD IV nor CRD V prescribe reporting requirements for IRRBB.

5 Capital buffers

CRD Articles 97, 104, 104a, 104b, 129, 130, 131, 133, 134, 136, 140, 141, 141a, 142(1), and 160

5.1 This chapter explains the PRA's proposed implementation of the SI's requirements for the O-SII buffer and the SRB.

5.2 The O-SII buffer and SRB are intended to ensure firms maintain a sufficient amount of capital above the regulatory minimum in order to reflect their domestic systemic importance and to address macroprudential or systemic risks not addressed by Pillar 1 minimum requirements. This reduces firms' likelihood of failure and so contributes to the PRA's achievement of its objectives.

5.3 The proposals in this chapter would make amendments to:

- SoP 'The PRA's approach to the implementation of the systemic risk buffer';
- SoP 'The PRA's methodologies for setting Pillar 2 capital';
- SoP 'The PRA's approach to identifying other systemically important institutions (O-SIIs)'
- SS31/15 'The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)';
- SS6/14 'Implementing CRD IV: Capital buffers';
- SS45/15 'The UK leverage ratio framework';
- SS16/16 'The minimum requirement for own funds and eligible liabilities (MREL) – buffers and Threshold Conditions'; and
- 'The PRA's approach to banking supervision'; and
- Voluntary Requirement (VREQ) – Capital Buffers and Pillar 2A Model Requirements.

Proposals

5.4 When transposing CRD IV, the UK implemented the SRB as the macroprudential tool that it would use to address the domestic systemic importance of ring-fenced bodies (RFBs). The UK's current SRB legislation requires the FPC to set a framework for the SRB, which the PRA applies to individual firms. The UK transposed the CRD IV requirement for the PRA to identify O-SIIs, but did not transpose the power for the PRA to apply the O-SII buffer.

5.5 CRD V amends the SRB and O-SII buffers. Under CRD V, the SRB may no longer be used to address a firm's domestic and global systemic importance; only the O-SII and G-SII buffers may be used for that purpose. CRD V also redefines the SRB, allowing it to be applied to prevent and mitigate macroprudential or systemic risks that are not covered by Pillar 1 requirements or the O-SII and G-SII buffers. CRD V's revisions to the SRB are intended to ensure the level of macroprudential flexibility is preserved given CRD V's amendments to the use of Pillar 2.[70] HMT has transposed these amendments through the SI.[71]

O-SII buffer

5.6 The SI grants the PRA a power to apply an O-SII buffer to replace the function currently performed by the SRB.[72] HMT's consultation document explained its dual objective would be to implement the O-SII buffer in a way that closely mirrors the existing SRB framework, and to ensure the new O-SII buffer addresses the risks currently dealt with by the SRB. The PRA proposes to implement the O-SII buffer in a way that achieves those objectives.

5.7 The SI mirrors the respective roles of the FPC and PRA for the O-SII buffer in the current SRB regulations:[73]

- the FPC would set the framework for the O-SII buffer and review it periodically; and
- the PRA would be able to apply an O-SII buffer to the same set of firms, and at the same level of consolidation, as for the existing SRB.

5.8 The PRA proposes not to amend its framework for the identification of O-SIIs, or to expand the range of firms to which a buffer rate applies.[74] Where the PRA decides to impose an O-SII buffer, the PRA would invite the relevant firm to apply for a VREQ to be imposed on it under section 55M of FSMA in order to set the buffer. The PRA proposes to amend the existing VREQ used to set the SRB to refer instead to the O-SII buffer (Appendix 4).[75]

5.9 The PRA proposes to amend SoP 'The PRA's approach to the implementation of the systemic risk buffer' to reflect the changes to the O-SII buffer. The changes the PRA proposes to make would consist primarily of administrative changes to ensure the O-SII buffer can apply to firms as the SRB does at present. The SI allows the PRA to apply the O-SII buffer to intermediate holding companies of ring-fenced bodies that may be required to comply with the CRR and CRD on a sub-consolidated basis, as discussed in Chapter 2 above.

5.10 In implementing the O-SII buffer, the PRA proposes to continue its current approach to addressing group risk that arises from setting a buffer at individual firm and sub-consolidated level, but not consolidated level. This would involve addressing the risk of 'double leverage' through the PRA Buffer applied at consolidated level. 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 quality forms of capital externally. This approach would ensure that sufficient capital of appropriate quality is held within, and distributed appropriately across, the consolidated group.

5.11 O-SII buffer rates set by the PRA would be cumulative with any SRB rate set by the PRA in future. Where an institution was subject to both a G-SII buffer and an O-SII buffer on the same basis of consolidation, the higher of the two would apply.

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70 CRD V amends CRD IV Articles 97(1)(b), 98(1)(j), 103, and 104(3)(d), removing: the assessment of systemic risk from the Supervisory Review and Evaluation Process; and supervisors' ability to use Pillar 2 to address systemic risk, or risks that firms with similar business models or geographical exposures might pose to the financial system.
71 Reg 14–20, SI.
72 S34ZC, The Capital Requirements (Amendment) (EU Exit) Regulations 2018, (Reg 18, SI).
73 S34ZA-34ZH, The Capital Requirements (Amendment) (EU Exit) Regulations 2018 (Reg 18, SI).
74 The PRA may identify a wider group of firms as O-SIIs than those to which it currently applies the O-SII buffer.
75 Voluntary Requirement (VREQ) – Capital Buffers and Pillar 2A Model Requirements: https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/authorisations/waivers-and-modifications-of-rules/vreq-capital-buffers-and-pillar-2a-model-requirements.pdf.

5.12 CRD V amends the terminology used to identify groups of firms as G-SIIs or O-SIIs.[76] This is reflected in the SI.[77] The PRA proposes to reflect that change when publishing its list of identified O-SIIs and G-SIIs, and to make a minor update to SoP 'The PRA's approach to identifying other systemically important institutions (O-SIIs)',[78] which will reflect how the change will apply in light of the UK's withdrawal from the EU. The PRA does not expect that the set of banking groups currently identified as O-SIIs and G-SIIs, or the obligations placed on firms, would change as a result of these amendments.

SRB

5.13 Under CRD V, the SRB can be used to implement a buffer for all or part of the financial sector, on exposures to particular sectors or sub-sectors, in order to address macroprudential or systemic risks not covered by Pillar 1 requirements or the O-SII buffer.[79] The SRB is additive to the higher of the G-SII buffer and the O-SII buffer, at the level of consolidation for which the buffer is set.

5.14 The SI confers on the PRA the power to set sectoral capital requirements for firms and approved holding companies via the revised CRD V SRB.[80] The PRA does not propose to set an SRB at the point the power is introduced.

5.15 The PRA proposes not to introduce an SRB at this time. However, the PRA may consult on introducing one in future should that be necessary and appropriate (for example, if the FPC were to direct the PRA to apply a sectoral capital requirement to PRA-authorised firms). The PRA and FPC would coordinate closely on any use of the tool.

Amendments to other buffers

5.16 CRD IV introduced three other capital buffers that may be applicable to firms:

- a capital conservation buffer (CCoB), set at 2.5% of a firm's risk-weighted assets at both group and solo level;[81]
- a countercyclical capital buffer (CCyB), where the firm-specific CCyB rate is a weighted average of the buffer rates that are being applied in jurisdictions to which the firm has a relevant credit exposure;[82] and
- a G-SII buffer, set on a firm-specific basis.[83]

5.17 The SI contains amendments to the frameworks for the CCoB, CCyB, and the G-SII buffer, which allow the PRA to apply these buffers to approved holding companies, as discussed in Chapter 3 above, and reflect the change in terminology in relation to the identification of G-SIIs referred to in paragraph 5.12 above.[84]

5.18 CRD V requires EU Member States to calculate an additional G-SII score for their banks, by excluding transactions between states in the European Banking Union from the cross-jurisdictional

76 Article 131(1).
77 Regs 16–17, SI.
78 February 2016: https://www.bankofengland.co.uk/prudential-regulation/publication/2016/the-pras-approach-to-identifying-other-systemically-important-institutions-o-siis-sop.
79 CRD V Article 133(1).
80 Part 5A Systemic Risk Buffer, The Capital Requirements (Amendment) (EU Exit) Regulations 2018 (Reg 19, SI).
81 CRD V Article 129.
82 CRD V Article 130.
83 CRD V Article 131.
84 Regs 13–15 and 20, SI.

activity indicators used as part of G-SII designation. The additional methodology would not result in a different G-SII buffer rate for UK firms. Therefore, the PRA does not propose to introduce this additional methodology into its calculation of G-SII buffer scores.

5.19 CRR II requires the PRA to set a G-SII leverage ratio buffer. As CRR II's G-SII leverage ratio buffer applies after the end of the transition period, the PRA proposes not to implement the requirement for a G-SII leverage ratio buffer.[85]

85 CRR Article 92(1a).

6 Maximum Distributable Amount (MDA)

CRD Article 141

6.1 This chapter sets out the PRA's proposed implementation of CRD V's requirements relating to the MDA that are applied to certain distributions when a firm uses its combined buffer. It also sets out additional changes to the MDA that the PRA proposes to make after the end of the transition period.

6.2 Buffer usability enhances the safety and soundness of firms, in line with the PRA's objectives. When firms use their combined buffer they become subject to automatic MDA restrictions on discretionary distributions (CET1 dividends, variable remuneration, Additional Tier 1 (AT1) coupons, and share buybacks), and must prepare a capital conservation plan.[86] [87] MDA requirements are designed to ensure that: (i) the combined buffer can be used when a firm is subject to stress; and (ii) that capital is appropriately conserved when the buffer is used. CRD V's amendments to the definition of MDA are intended to make it easier for a firm to use the combined buffer.

6.3 The proposals in this chapter would make amendments to:

- the Capital Buffers Part of the PRA Rulebook;[88]
- SS6/14 'Implementing CRD IV: Capital buffers'; and
- VREQ – Capital Buffers and Pillar 2A Model Requirements.

Proposals

Amendments to MDA that implement CRD V

6.4 CRD IV restricts firms' distributions to a percentage of profits made since their last distribution. CRD V modifies that restriction to permit firms to distribute interim and year-end profits (net of distributions) that are not included in CET1 capital resources, irrespective of the timing of the last distribution. This increases the maximum amount that firms would be permitted to distribute when they use the combined buffer.[89]

6.5 The PRA proposes to implement these amendments by updating SS6/14, Rule 4.3 of the Capital Buffers Part of the PRA Rulebook, and the existing model VREQ. The PRA considers that the amendments would increase the ability of firms to use their combined buffer in a severe but plausible stress.[90] The PRA proposes to apply the revised MDA requirement from Tuesday 29 December 2020 until the end of the transition period.

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86 This CP and Rule 4.3 of the Capital Buffers Part of the PRA Rulebook do not address the PRA's expectations on the relationship between MREL and buffers, which are set out in PRA SS16/16 'The minimum requirement for own funds and eligible liabilities (MREL) – buffers and Threshold Conditions'. The PRA published a statement on its website relating to the interaction of MREL and buffers in light of the introduction of total loss-absorbing capacity (TLAC) requirements in CRR II. The PRA does not consider that further changes are needed at this stage.

87 Capital Buffers 4.3 or (for firms subject to a Pillar 2A capital requirement, G-SII buffer, or SRB) the Voluntary Requirement (VREQ) – Capital Buffers and Pillar 2A Model Requirements (which applies in place of Rule 4.3).

88 The amendments to the MDA provisions of the PRA Rulebook will apply only to PRA-authorised firms (including firms designated to be responsible for consolidated requirements pending holding company approval). When holding companies are approved, the PRA intends to use its power of direction over qualifying parent undertakings to apply the revised MDA requirements.

89 Article 141 of CRD V.

90 This CP and Capital Buffers 4.3 do not address the PRA's expectations on the relationship between MREL and buffers, which are set out in SS16/16 'The minimum requirement for own funds and eligible liabilities (MREL)' buffers and Threshold Conditions. The PRA published a statement on its website relating to the interaction of MREL and buffers in light of the introduction of TLAC requirements in CRR II. The PRA does not consider that further changes are needed at this stage.

Further amendments to MDA after the end of the transition period

6.6 The PRA considers further changes to the definition of the MDA to be required in order to improve firms' ability to use their combined buffers as intended when subject to a severe but plausible stress. The PRA proposes to amend the definition of the MDA from the end of the transition period. These amendments are consistent with BCBS standards and seek to:

- limit incentives to hold excessive management buffers, or deleverage, rather than use the combined buffer; and
- help to ensure consistent outcomes across firms.

Distributions that result in the combined buffer being used

6.7 CRD IV requires that the PRA's existing approach precludes firms from making distributions that would cause their CET1 levels to fall into the combined buffer; CRD V does not amend this requirement.[91] This restriction is not specified in BCBS standards. The PRA considers that this restriction increases the incentives for firms to hold higher management buffers in addition to the combined buffer.

6.8 In order to increase the usability of the combined buffer, the PRA proposes to remove this restriction after the transition period ends. This would allow a firm to make a distribution that would cause its CET1 level to fall within the combined buffer. To support this discretion, the PRA also proposes that firms should provide the PRA with advance notice (though not explicitly request permission) of any distribution that would bring a firm's capital levels into the combined buffer. The PRA's proposed approach is consistent with the requirements of the relevant BCBS standard.

MDA definition

6.9 Once a firm uses its combined buffer, CRD V defines the MDA as interim and year-end profits net of distributions. However, it does not permit profits that already count towards CET1 resources to be distributed.[92] As a result, firms that recognise profit as CET1 capital more frequently will have a smaller MDA. It also reduces the extent to which the combined buffer may be used in practice.

6.10 In order to strike an appropriate balance between buffer usability and capital conservation, the PRA proposes to amend, after the end of the transition period, the definition of the MDA, to include certain profits already recognised as CET1. To limit the amount of historically recognised CET1 included in the MDA, the PRA proposes to only include profits from the past four calendar quarters, net of distributions. The PRA proposes to define 'profits from the past four calendar quarters net of distributions' as the sum of all earnings over the four calendar quarters preceding the relevant date, less the sum of (a) and (b) below:

(a) Any distributions of profits or payments related to:

  i) distributions in connection with CET1 capital;

  ii) an obligation to pay variable remuneration or discretionary pension benefits, or pay variable remuneration or discretionary pension benefits, if the obligation to pay was created at a time when the firm did not meet the combined buffer; and

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91 The PRA's current approach implements Article 141 of CRD IV. The approach is implemented by Capital Buffers 4.3 or (for firms subject to a Pillar 2A capital requirement, G-SII buffer, or SRB) the Voluntary Requirement (VREQ) – Capital Buffers and Pillar 2A Model Requirements (which applies in place of Rule 4.3).

92 Article 141 of CRD V.

iii) payments on AT1 instruments.

(b) Amounts which would be payable by tax if the undistributed profits of the past four calendar quarters were to be retained.

6.11 The PRA also considers the proposed definition of distributable profits to provide a straightforward way to adjust the definition of the MDA to increase buffer usability. However, the PRA recognises that, under this proposal, a large distribution in one quarter would reduce available earnings for the calculation of the MDA in the subsequent four quarters. As a result, a firm could have few resources to distribute if it were to breach buffers shortly after making a large distribution, even it continued to be profitable. The PRA considers that such a concern could be mitigated by the fact that distributions are generally spread throughout the year.

6.12 The PRA considers that this approach would improve the consistency of outcomes across firms, reduce incentives for firms to hold management buffers in excess of the combined buffer, and ensure that the profits that may be distributed reasonably reflect a firm's recent financial performance. The proposed approach is consistent with the BCBS standard.

Question

3. Would the proposed amendments increase the usability of the combined buffer, and if so, to what extent?

7 Pillar 2

CRD Articles 104a and 104b

7.1 This chapter explains further clarifications regarding changes CRD V makes to Pillar 2. This chapter builds on changes described in Chapter 2 of CP12/20.

7.2 Requirements for Pillar 2A to be met with a minimum amount of CET1 capital enhances the safety and soundness of firms, in line with the PRA's objectives.

7.3 The proposals in this chapter would make amendments to:

- SS31/15 'The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)'; and

- VREQ – Capital Buffers and Pillar 2A Model Requirements.

Proposals

Quality of capital for Pillar 2A

7.4 The PRA currently requires Pillar 2A to be met with 56% of CET1 capital. As set out in PS7/13, this was intended to meet Pillar 2A risks with the same quality of capital as Pillar 1.[93] This will help to enhance firms' safety and soundness.

7.5 In CP12/20, the PRA stated that the CRD V requirement was aligned with the PRA's current approach. However, under CRD V, firms are required to meet Pillar 2 Requirements (which are implemented by the PRA as Pillar 2A) with at least 56.25% CET1 capital, consistent with the proportion of Pillar 1 requirements CRR required to be met with CET1 capital.[94] The PRA proposes to align with CRD V and require firms to meet Pillar 2A with 56.25% CET1. The PRA proposes to amend SS31/15 and the existing model VREQ accordingly.

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93 December 2013: https://www.bankofengland.co.uk/prudential-regulation/publication/2013/strengthening-capital-standards-implementing-crd-4.

94 Paragraph 2.16, September 2020: https://www.bankofengland.co.uk/prudential-regulation/publication/2020/capital-requirements-directive-v; Article 104a(4) of CRD V.

8 Governance

CRD Article 91

8.1 This chapter sets out the PRA's proposals to implement aspects of CRD V requirements on governance that were not addressed in CP12/20.

8.2 The CRD V provisions on governance are intended to ensure that firms and their management organise and control their affairs responsibly and effectively. Sound governance practices and procedures enhance the safety and soundness of firms, in line with the PRA's objectives.

8.3 The proposals in this chapter would make amendments to:

- the General Organisational Requirements Part of the PRA Rulebook; and
- SS28/15 'Strengthening accountability in banking'.

Proposals

Governance arrangements

8.4 In CP12/20, the PRA consulted on implementing CRD V's governance requirements. It did not address the application of those requirements to approved holding companies.

8.5 In addition to the proposals in CP12/20, the PRA proposes to apply CRD V's governance requirements to approved holding companies on a consolidated basis or sub-consolidated basis, including requirements on fitness and propriety in General Organisational Requirements and the obligations to maintain policies and report details in respect of related party transactions.[95]

8.6 These proposals would help to ensure that firms' consolidated governance arrangements support prudent decision making and risk management. This in turn would enhance the safety and soundness of firms.

Verification of fitness and propriety: Notified non-executive directors (NEDs)

8.7 CRD V requires supervisors to verify that members of a firm's management body continue to meet CRD requirements for fitness and propriety where supervisors have reasonable grounds to suspect that:

- money laundering or terrorist financing (MLTF) is being or has been committed or attempted; or
- there is an increased risk of MLTF.[96]

8.8 In CP12/20, the PRA consulted on proposals to implement this new requirement, including its application to notified NEDs. In order to clarify the PRA's expectations of fitness and propriety of notified NEDs explicitly in such cases, the PRA proposes to amend SS28/15.

[95] CRD Article 109(2).
[96] CRD V Article 91(1).

Part Two

9 Variable risk weights for real estate exposures

CRR Article 124

9.1 This chapter sets out the PRA's proposed implementation of a discretion under CRR II to set stricter criteria than those specified in CRR, in order to apply a 50% risk weight to commercial real estate (CRE) exposures under the Standardised Approach to credit risk (SA).

9.2 The proposals in this chapter would amend the Credit Risk Part of the PRA Rulebook.

Proposals

Designated authority

9.3 CRR specifies that supervisors must assess at least annually the appropriateness of capital requirements for real estate exposures based on loss experience and forward-looking market developments. It also gives them discretion to set stricter capital requirements, or stricter criteria, for certain real estate exposures on the basis of financial stability considerations.[97]

9.4 CRR II requires an EU Member State to designate the supervisory or macroprudential authority as responsible for this assessment, and for setting higher capital requirements or stricter criteria where the inadequacy of capital requirements could adversely affect current or future financial stability in that Member State.[98]

9.5 The SI designates the PRA as the UK authority for these purposes, consistent with its current role in implementing CRR Articles 124 and 164.[99] The PRA will ensure the FPC is appropriately involved in the assessment of financial stability concerns in the UK, as is required in order to use the tool. It will also ensure appropriate co-ordination and exchange of information with the FPC.

Standardised Approach to credit risk (SA)

9.6 The PRA implemented the discretion under CRR to apply stricter criteria for the application of the 50% risk weight for CRE exposures, under the SA.[100]

9.7 The PRA considers that the application of a 50% risk weight to CRE exposures under the SA would be inadequate and could adversely affect current or future financial stability in the UK. Therefore, the PRA proposes not to make substantive changes to Credit Risk Chapter 4, but to update it to reflect cross references to amended reporting requirements for losses on real estate exposures.[101]

Stricter criteria

9.8 For the reasons set out below, the PRA considers firms not to be able to comply with the stricter criteria set out under Credit Risk 4.1 and 4.1A at this time. As a result, the 50% risk weight for CRE

97 CRR Articles 124 and 164.
98 CRR II Article 124(1a).
99 Amendment of the Capital Requirements Regulations 2013, (Reg,4 SI).
100 Rules 4.1 and 4.1A in Credit Risk Chapter 4.
101 CRR II moves the relevant reporting requirement from Article 101(3) to a new Article 430a.

exposures set out under CRR II Article 126(1) would not be applicable for UK and non-EEA commercial real estate exposures, and the CRR II would require a 100% risk weight to be applied.[102]

- For the purposes of Credit Risk 4.1 and 4.1A, Credit Risk 4.2 specifies that 'a representative period shall be a time horizon of sufficient length and which includes a mix of good and bad years'. The PRA does not consider the requirements of 'a representative period' to have been met, as current data do not cover an adequate mix of good and bad years. The PRA considers that a full credit cycle must be observed in the UK (or a given non-EEA jurisdiction) CRE market before these data would be available. For this reason, the PRA does not publish the aggregate market data for commercial property lending required to assess compliance with Credit Risk 4.1.

- The data published by the PRA under CRR II Article 430a(3) would not enable firms to make the determination required under Credit Risk 4.1. The PRA is also not currently aware of any data published by non-EEA jurisdictions which would enable firms to make the determination required under Credit Risk 4.1A. As a result, exposures secured by mortgages on commercial immovable property cannot currently be treated as 'fully secured', and the 50% risk weight under CRR II Article 126(1) cannot currently be applied.

102 Article 124(1).

10 Methods of consolidation

CRR Article 18

10.1 This chapter sets out the PRA's proposed approach to the implementation of CRR II's requirements on methods of consolidation.

10.2 CRR II introduces a number of changes to the methods of consolidation that will apply directly to firms from Monday 28 December 2020. The application of prudential requirements to firms' consolidated groups helps to ensure the safety and soundness of the members of the group.

10.3 The proposals in this chapter would require amendments to:

- the Groups Part of the PRA Rulebook; and
- SS15/13 'Groups'.

Proposals

Equity method

10.4 CRR II requires firms to use the equity method to value subsidiaries that are not banks or investment firms, financial institutions, or ancillary services undertakings, or their participations in such entities.[103] However, it also gives supervisors discretion to allow or require firms to apply a different method where:[104]

- a firm is not already applying the equity method;
- it would be unduly burdensome to apply the equity method or it does not adequately reflect the risks; and
- the equity method would not result in full or proportional consolidation of the undertaking.

10.5 The PRA proposes to update SS15/13 to highlight that firms may apply for permission to use a method other than the equity method where these criteria are met. The PRA proposes (on a case-by-case basis) to require the use of another method, (eg the method applied under the applicable accounting standards), where it determines the use of the equity method is unduly burdensome to apply or does not adequately reflect the underlying risks of the firm's holdings .

Step-in risk

10.6 CRR II gives supervisors discretion to require full or proportional consolidation of a non-financial entity, in which a firm has a participation where there is a substantial risk that the firm will provide support beyond any obligations it has to provide such support (substantial step-in risk).[105] This is consistent with guidelines drawn up by the BCBS relating to step-in risk.[106]

10.7 The PRA proposes to amend SS15/13 to highlight the PRA's intention to consider on a case-by-case basis whether the consolidation of an entity is necessary to address substantial step-in risk.

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103 CRR II Article 18(7).
104 CRR II Article 18(7).
105 Step-in risk is defined in CRR II Article 18(8) as 'a substantial risk that the institution decides to provide financial support to that undertaking in stressed conditions, in the absence of, or in excess of any contractual obligations to provide such support'.
106 Basel Committee on Banking Supervision, October 2017: https://www.bis.org/bcbs/publ/d423.htm.

Further proposals

10.8 The PRA also proposes to make amendments to the methods of consolidation rules within the Groups Part.

10.9 CRR specifies the methods of consolidation to be applied, depending on the relationship between a firm and the entity in which it has a holding. Where the entity is a subsidiary of the firm, CRR requires full consolidation.[107] For participations, CRR either requires proportional consolidation or permits supervisors to determine how consolidation should be carried out, depending on the relationship.[108] Draft EBA Regulatory Technical Standards (RTS) on the methods of consolidation clarify further how consolidation should be carried out in such cases.[109] [110]

10.10 The EBA's draft RTS on the methods of consolidation clarify that proportional consolidation must be applied where a firm has a participation that is a 'joint arrangement' (ie a joint operation or joint venture).[111] [112] The PRA currently requires proportional consolidation in a broader range of cases than only joint operations or joint ventures. For certain other cases of participations or capital ties, CRR permits the supervisor to determine whether and how consolidation should be carried out.[113]

10.11 Having considered the EBA's approach, the PRA proposes to amend its general approach to an 'Article 18(5) relationship' within the PRA Rulebook to require proportional rather than full consolidation. Applying this approach would continue to be prudent, as appropriate consolidation would be applied. It would also be more proportionate, as full consolidation is unlikely to be necessary in cases where a firm has a participation rather than owning a subsidiary. The PRA also proposes to make consequential amendments to SS15/13 to reflect this change, and to amend the PRA Rulebook Glossary definition of an 'Article 18(5) relationship' to make it consistent with the CRR text.

10.12 The PRA also proposes to make a number of amendments to cross-referencing within the PRA Rulebook to clarify the circumstances in which the PRA is required to determine the method of consolidation where there is a 'common management' relationship between relevant undertakings.[114] The PRA proposes to amend this to refer to an 'Article 22(7) relationship'. This is necessary to implement a change in CRR II's cross referencing to the EU Financial Statements Directive (FSD).[115]

10.13 The PRA proposes to make a further amendment from the end of the transition period to refer to the 'common management relationship', as per the definition within the onshored version of the CRR that replicates the substance of Article 22(7) FSD. (Article 22(7) FSD has not otherwise been onshored into UK legislation.) 'Common management relationship' is defined in the PRA Rulebook Glossary.

107 CRR Article 18(1).
108 CRR Article 18(2)–(6).
109 This draft technical standard has not yet been adopted by the European Commission.
110 '[Consultation Paper: Draft Regulatory Technical Standards on the methods of prudential consolidation under Article 18 of Regulation (EU) No 575/2013 (Capital Requirements Regulation - CRR)'](), European Banking Authority, November 2017.
111 CRR Article 4(1)(35) states that '"participation" means participation within the meaning of the first sentence of Article 17 of Fourth Council Directive 78/660/EEC of 25 July 1978 on the annual accounts of certain types of companies, or the ownership, direct or indirect, of 20 % or more of the voting rights or capital of an undertaking'.
112 CRR Article 18(4).
113 CRR Article 18(5).
114 The current CRR Article 18(3).
115 Article 22(7), Directive 2013/34/EU.

11 The PRA's statutory obligations

11.1 In carrying out its policy making functions, the PRA is required to comply with several legal obligations. Before making any rules, FSMA[116] 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,[117] and secondary competition objective;[118]
- 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;[119] and
- a statement as to whether the impact of the proposed rules will be significantly different to mutuals than to other persons.[120]

11.2 The PRC should have regard to aspects of the Government's economic policy as recommended by HMT.[121]

11.3 The PRA is also required by the Equality Act 2010[122] 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

11.4 This section sets out an analysis of the costs and benefits of introducing those elements of CRD V for which proposals are set out in this CP. The PRA has not included quantitative estimates for most measures in this analysis, as it does not anticipate that the costs to firms would be large or material.[123] Moreover, the compressed timetable for transposition of the proposals, and the demands on both the PRA's and firms' resources in the current economic environment, meant that a data collection to support additional quantitative analysis would not be proportionate.

11.5 CRD V is part of the EU's risk reduction package used to implement, in the EU, reforms agreed at an international level following the 2007–2008 financial crisis. As such, the costs and benefits of CRD V need to be considered in the context of all measures addressing financial stability. Moreover, a number of these measures are intended to ensure that the benefits of measures already introduced would be realised. The PRA estimated that the net benefits of all prudential measures in

116 Section 138J of FSMA.
117 Section 2B of FSMA.
118 Section 2H(1) of FSMA.
119 Sections 2H(2) and 3B of FSMA.
120 Section 138K of FSMA.
121 Section 30B of the Bank of England Act 1998.
122 Section 149.
123 This CP does not make proposals on potential fees applicable to FHCs and MFHCs or the information the PRA would require to facilitate ongoing monitoring of compliance with approval conditions, and conditions for exemption from approval, set out in HMT's proposed bespoke regime for holding company approval and exemptions from approval. Therefore, this chapter does not address the costs of those aspects.

response to the financial crisis at the time of the CRD IV package,[124] which implemented the Basel III reforms within the EU in 2015, would be approximately £8.25 billion per annum.[125]

11.6 The expected costs and benefits to firms and the PRA arising from the specific proposals in this CP are set out below. Table 1 sets out the expected impacts on firms for each policy proposal by benefit, cost, and no incremental change. In summary, the PRA identified additional benefits in this CP arising from the proposals addressing the MDA, IRRBB, and holding companies. It also identified additional one-off material costs arising from the proposed requirements for holding companies of approximately £170,000–£290,000 across 60 affected firms. The PRA does not expect any other additional material costs to arise from the proposals.

11.7 As the PRA has already consulted on a number of elements of CRD V in CP12/20, those measures are included in Table 1 to provide context for the CRD V as a whole.[126] In CP12/20, the PRA identified additional benefits arising from the proposals addressing Pillar 2 (duplicative reporting) and remuneration. The PRA also identified that material costs would arise from the proposals on remuneration and intermediate parent undertakings (IPUs). Where cost estimates are possible, the PRA estimated: additional one-off costs ranging from £875,000 to £4.4 million, and from £87,000 to £440,000, for large and small firms, respectively; and additional ongoing costs ranging from £350,000 to £1.3 million per annum, and from £44,000 to £175,000 per annum, for large and small firms, respectively.

Table 1:[1] Costs and benefits of CRD V policy areas

		Policy areas
Additional benefits of measures		**MDA; IRRBB; Holding companies**
		Pillar 2 (duplicative reporting); Remuneration (share-linked instruments)
Additional costs of measures	Material	**Holding companies**
		Remuneration; IPUs
	Not material	**Application of consolidated requirements; Capital buffers; Pillar 2; MDA;**
		Third-country branch reporting; Pillar 2 (PRA buffer); Governance (loans to board members)
No substantial change in approach / no additional costs		**IRRBB; Governance; Methods of consolidation; Variable risk weights for real estate exposures**
		SREP; Tailored methodology; Pillar 2A; MLTF; Governance

1 Proposals included in this paper are marked in **bold**. Elements of CRD V included in CP12/20, 'Capital Requirements Directive V (CRD V)' are marked in grey. CP12/20 is available at https://www.bankofengland.co.uk/prudential-regulation/publication/2020/capital-requirements-directive-v.

11.8 Given the significant net benefits expected of the CRD IV measures currently in place to which these proposals are expected to contribute, the PRA expects the measures introduced in CRD V to continue to have net benefits for the UK financial system and the UK economy as a whole.

Affected firms and markets

11.9 The proposals in this CP apply to all CRR firms regulated by the PRA, and to those holding companies that fall into the scope of CRD Article 21a. There are 403 PRA-authorised CRR firms in total,[127] comprising 352 banks, 43 building societies, and 8 designated investment firms, at the time of the PRA Business Plan 2020/21.[128] We also anticipate that around 60 holding companies will fall in scope of the specific holding company proposals, requiring approval or exemption from approval.

124 August 2013: https://www.bankofengland.co.uk/prudential-regulation/publication/2013/strengthening-capital-standards-implementing-crd-4.
125 Annualised net present value of the chain-volume measure (2012) of GDP.
126 https://www.bankofengland.co.uk/prudential-regulation/publication/2020/capital-requirements-directive-v.
127 The exact number of these firms and groups changes as new firms enter, other firms close or vary their permission, and entities within groups restructure.
128 April 2020: https://www.bankofengland.co.uk/prudential-regulation/publication/2020/pra-business-plan-2020-21.

Not all the proposals in this CP would be relevant for all firms. Some proposals (such as those for holding companies, capital buffers, methods of consolidation, and variable risk weights for real exposures) would only have a direct impact on those CRR firms, or FHCs or MHCs, the business models of which are directly affected by the proposals. Nevertheless, where a CRR firm is not currently subject to the proposals set out in this CP, changes to their business models could bring them within scope of the new requirements in future. The proposals do not directly affect other PRA-regulated firms.

11.10 The markets in which the affected firms operate, and which are most relevant to the proposals in this CP, cover those products most closely associated with the credit intermediation process, including deposit-taking, retail and wholesale lending, and interbank lending. As many banks have the capacity to cross-subsidise operations across business lines, it is possible that the proposals in this CP could also affect other markets, although the PRA does not think this is likely. Moreover, the proposals are likely to have a minor impact on the administrative costs of affected firms and so are not expected to have any specific effects on any market for services provided by PRA-regulated firms.

Benefits

11.11 The PRA expects that the following measures would generate additional benefits, in addition to helping realise the net benefits expected from all measures promoting financial stability.

- MDA: the CRD V amendment to the definition of MDA would allow firms to distribute profits from the previous financial year that are not included in CET1 resources, regardless of the timing of the last distribution date. This is beneficial for firms as it would provide greater flexibility to manage capital and dividend payout planning.

  There are additional benefits from the PRA's further amendments which will come into effect after the transition period, in particular allowing firms' CET1 levels to fall into the combined buffer when making distributions. Greater clarity and flexibility may reduce market frictions associated with raising capital, and could increase the market value of firms by attracting more investors. It may also encourage banks to reduce the voluntary surplus they hold over capital requirements, making capital buffers more usable in practice. Reducing the cost of capital of firms could strengthen safety and soundness. This could be achieved by reducing future funding costs and incentives to deleverage that could unnecessarily compromise a firm's future profitability and damage financial stability.

- IRRBB: in the absence of the PRA's transposition of requirements for IRRBB into PRA rules and supervisory expectations following the transition period, there would be a risk to the PRA's safety and soundness objective. Firms would otherwise be subject only to a supervisory expectation to make every effort to comply with EBA GLs that seek to implement BCBS standards. The benefits of the IRRBB proposals are therefore to help to ensure that IRRBB continues to be appropriately implemented by firms, and to introduce a standardised framework that firms may choose to use, or which could serve as a fall back approach in the event firms' internal systems were not adequate.

- Holding companies: the PRA's proposed approach to managing the process of holding company approval would enable the PRA to make the most efficient use of its resources, and help firms to understand the requirements to which they are subject. It should also help to make the process clearer and more efficient for firms.

Costs

11.12 As noted in Table 1 above, the proposals set out in this CP fall into three categories, according to the materiality of expected costs to firms: (i) material costs; (ii) non-material costs; and (iii) no substantial change in approach or no incremental costs.

Material costs

11.13 This section sets out the material costs the PRA expects to arise from the proposals in this CP. While the PRA anticipates that these costs are material, the current economic environment and the response to Covid-19 has limited both the PRA's ability to investigate costs, and firms' capacity to respond to PRA requests. Therefore, quantitative estimates are provided only where it has been proportionate to do so.

- Holding companies: the PRA's approach to obtaining information in support of an application for approval would generate material, though not large, costs for firms.[129] Holding companies would need to gather information from around the group to support their application for approval or exemption for approval, and present it in the manner suggested by the PRA. However, the PRA expects that the information needed for the application process is readily available to holding companies as (i) the structure of the group is known, and (ii) operating banks reporting to the holding company already provide the required information to the PRA. Consequently, the PRA does not expect the incremental costs of this proposal to extend beyond the standard administrative costs of preparing the application itself.

  The PRA estimates that gathering and compiling the information needed for the application would require between six and ten full-time equivalent (FTE) days per application, including senior management oversight, depending on the complexity of the group structure. It expects that approximately 60 holding companies would make an application for approval or exemption from approval, so the total expected cost to affected firms is in a range of approximately £170,000 to £290,000.[130] [131]

  The administrative costs to firms of the movement of responsibility from operating banks and PRA-designated investment firms to approved holding companies may also generate some cost savings over the longer term. Groups with more than one operating bank or PRA-designated investment firm would no longer duplicate the ongoing costs of demonstrating that consolidated requirements are met. Moreover, linking responsibility for meeting consolidated requirements may reduce ad hoc costs, including data and information requests associated with PRA supervision. The PRA has not attempted to estimate this potential saving, as it would not be a proportionate use of their resources to do so, although the total costs of the proposals may subsequently be reduced over time.

Non-material costs

11.14 This section sets out the costs that arise as a result of the proposals that are not expected to be material. The PRA has not provided quantitative estimates of these costs, as the proposals either: reflect minor administrative changes for firms, or for the PRA reflect 'business as usual'; or provide firms with greater discretion in stress for which there is no current experience.

129 The CRD V requirements for holding company approval would be covered by the bespoke regime on which HMT consulted in July 2020. This chapter does not cover the costs of the requirements to be covered by that regime.

130 The FTE cost per day is based on the 2019 Robert Walters Salary Survey data for regulatory reporting roles in banking and financial services, using the mid-point of the range of the contract rate per day. See https://www.robertwaltersgroup.com/content/dam/robert-walters/global/files/salary-survey/salary-survey-2019-uk.pdf.

131 This CP does not set out the information the PRA would require in order to assess ongoing compliance with the requirements for holding company approval or exemption from approval. The PRA intends to develop its approach to ongoing information once it has finalised the template required for approval, and in light of comments from stakeholders on the PRA's approach to it.

- Pillar 2: the proposals on Pillar 2 to require firms to hold 56.25% of Pillar 2A in CET1 capital, rather than 56%, will change firms' capital requirements marginally. The PRA estimates that aggregate CET1 requirements for all firms will increase by approximately £250 million, or around 1 basis point of risk-weighted assets. This represents approximately 0.18% of firms' current surplus of CET1 resources over their current CET1 requirements. The PRA does not expect this change to requirements to be material, as it can be met by firms' existing capital resources and factored into existing business plans. The PRA does not expect firms' capital resources to change as a result of this proposal.

  The change to the requirement will also slightly raise the point at which firms enter their combined buffers and are subject to MDA restrictions. However, the costs of that to firms would be offset, to some extent, by the proposals on MDA in this CP, which seek to improve the usability of capital buffers.

- O-SII buffer: the PRA expects that the proposal to set an O-SII buffer to replace the existing SRB would only incur minor additional administrative costs for firms to implement. These administrative costs include ensuring that firms' compliance functions are aware of the changes. The PRA does not consider it proportionate to estimate this cost, particularly as the attention of affected firms is appropriately focused on other issues arising from the Covid-19 response. No changes to firms' capital or other requirements would arise as a result of this change.

  Moreover, the PRA does not intend to change its approach to setting additional loss absorbency for domestic systemically important banks and building societies.

- SRB: the PRA is not proposing to implement an SRB at this time. Therefore, the PRA expects the costs of its capital buffer proposals to be non-material.

- MDA: the MDA proposals remove some existing restrictions on distributions, which should reduce costs for firms that used the combined buffer. Moreover, the proposals, applicable after the end of the transition period, would allow firms to make distributions that caused them to enter their combined buffer. In the absence of these proposals, firms could face relatively higher costs of raising capital if investors perceived them to be more likely to be subject to automatic restrictions on distributions. As these cost savings would only be evident when firms use their combined buffer, and are dependent upon the strategic decisions of firms at that point, it is not possible for the PRA to provide quantitative estimates of the cost savings.

- Application of consolidated requirements: the proposals on applying consolidated requirements to approved holding companies are likely to generate some additional one-off compliance costs for firms, although these costs are not expected to be material. Approved holding companies will incur costs to ensure that they can demonstrate to supervisors that they are responsible for meeting requirements at the appropriate level. However, as this role is already performed by firms at an operating level, the PRA expects that this function can be relatively easily transferred within the group. Moreover, where there may be more than one operating bank within the group performing this function, there may be some reduction to ongoing costs for the group as a whole. In the current economic environment, the PRA does not think it would be proportionate to attempt to quantitatively estimate these costs. The amendments proposed to the consolidated governance arrangements in Chapters 3 and 8 apply consolidated obligations to approved holding companies, and may create an initial cost to approved holding companies in ensuring they are meeting the new requirements. Approved holding companies would initially need to gather information regarding the existing consolidated governance arrangements and assess whether they meet the new obligations. However, the PRA expects that the information needed would be readily available, which will limit the cost to approved holding companies.

No substantial change in approach or no incremental costs

11.15 The proposals discussed in this section generally reflect consequential changes to PRA rules that reflect existing practice, or would have incremental costs only where firms choose to make use of provisions (but would not face additional costs otherwise).

- Governance: the proposals on the fitness and propriety of notified NEDs in relation to MLTF do not change the PRA's existing approach in substance and would not generate costs for firms. The proposals on NEDs in relation to MLTF is intended to clarify the requirements already set out in CP12/20.[132]

- IRRBB: the proposals for management of the IRRBB, outlier tests, and inclusion of the IRRBB in Pillar 2A and reporting seek to implement current requirements within PRA rules and expectations. Therefore, the PRA considers that they would not represent a substantial change to the PRA's existing approach to these issues. As a result, the PRA does not expect significant costs to arise for firms as a result of these proposals.

  The new standardised framework for calculating interest rate risk and the effect on economic value of equity is expected to have one-off set-up costs for firms. However, the PRA's proposed use of the standardised framework is generally at firms' discretion. As firms already have processes in place to make their own calculations using internal systems, the PRA expects that adopting the standardised framework would be economical, as the one-off set-up costs are likely to be offset by cost savings to the existing process. Consequently, the PRA does not anticipate any costs to firms arising from the introduction of the standardised framework.

  Clarification of supervisory actions that could be taken where a firm's IRRBB is excessive, or its management inadequate, is also expected to have no incremental compliance costs for firms. The cost to firms of any actions the supervisor may take in response to inadequate management of IRRBB are proportionate and not incremental to these proposals. There would, however, be additional costs to firms if a decision to take supervisory action was not proportionate, or if the action taken was disproportionate to address the prudential concern. The PRA expects that its supervisory processes will help to ensure that decisions on the level and management of firms' IRRBB are proportionate, and that any mitigating actions are effective and proportionate.

- Methods of consolidation: the proposals on methods of consolidation do not reflect a substantial change to the PRA's current approach. The PRA expects the discretion exercised under CRR Article 18(7) would formalise the approach that firms may already use for the valuation of their holdings. The introduction of a rule to require full or proportional consolidation would have an impact only on firms where there is a step-in risk which would otherwise not be taken into account. The PRA expects that requiring firms to take a consolidation approach is proportionate where step-in risk is identified. The amendment to Groups 2.3 would require proportional rather than full consolidation, as the default to an 'Article 18(5) relationship' reflects the PRA's existing practice. The treatment of ancillary services undertakings under Article 18(2) also reflects the PRA's existing practice.

132 July 2020: https://www.bankofengland.co.uk/prudential-regulation/publication/2020/capital-requirements-directive-v.

The PRA therefore does not expect that the proposals on methods of consolidation would have any incremental costs for firms.

- Variable risk weights for real estate exposures: the proposals on variable risk weights for real estate exposures are not expected to lead to consequential changes for firms. The proposals amend the PRA Rulebook to reflect amendments to the CRR, but otherwise would not change the PRA's current assessment of conditions that could affect risk weights for mortgages on commercial immovable property. The costs and benefits of the 50% risk weight, set out under Credit Risk 4.1 and 4.1A, were included in the assessment in 2013 of the CRD IV package, and are not incremental to these proposals.[133]

Compatibility with the PRA's objectives

11.16 The PRA considers that the proposals in this CP advance its general objective to promote the safety and soundness of PRA-authorised firms. In particular, the PRA's proposals intend to ensure that IRRBB would continue to be appropriately taken into account in firms' risk considerations, increase firms' flexibility to use their buffers in times of stress in order to enhance their financial resilience, and ensure sound governance practices and procedures.

11.17 The PRA has a secondary objective to facilitate effective competition. The PRA does not expect the proposals to have a material impact on competition. It has not identified any impacts on firms that are likely to: materially affect the operating costs of any cohort of affected firms that compete in the relevant markets; or materially change the behaviour of any particular firms. Consequently, the PRA does not expect that these proposals would have an impact on competition, and as such they are consistent with the PRA's secondary competition objective.

Regulatory principles

11.18 In developing the proposals in this CP, the PRA has had regard to the regulatory principles. Three principles are of particular significance for these proposals.

11.19 The principle that the PRA's resources are used in the most efficient and economical way. The proposals would support the PRA in supervising firms in an efficient and effective way. For example, the PRA's proposed holding company approval process and associated information templates would enable the PRA to focus its consolidated supervision on the entity that contains the decision making of the consolidated or sub-consolidated group.

11.20 The principle that a burden imposed on a PRA-authorised person should be proportionate to the benefits expected to result from that burden. The PRA considers that the proposals outlined in this CP are proportionate to the cost for firms in implementing and meeting the requirements on an ongoing basis, and will be proportionate to firms' size and complexity. In particular, the PRA does not propose to implement any additional outlier tests for IRRBB based on NII measures at this stage, given the heterogeneity in the size and complexity of firms' IRRBB positions. For holding company approval, the information the PRA proposes that holding companies provide in support of applications for approval or exemption are proportionate and targeted on the specific information required.

11.21 The principle that the PRA should exercise its functions transparently. The PRA has followed this principle when developing the proposals outlined in this CP. The PRA consults in this CP on

[133] See CP5/13 'Strengthening Capital Standards: Implementing CRD IV', August 2013: https://www.bankofengland.co.uk/prudential-regulation/publication/2013/strengthening-capital-standards-implementing-crd-4.

clarifying how its approach aligns with CRD V requirements, and sets out these proposed clarifications in SSs and SoPs. For example, the PRA proposes to make explicit that its MLTF proposals in CP12/20 apply to the expectations of fitness and propriety of notified NEDs.

Impact on mutuals

11.22 The PRA considers that the impact of the proposed rule changes and expectations on mutuals would not differ from the impact on other firms.

HM Treasury recommendation letter

11.23 HMT has made recommendations to the Prudential Regulation Committee (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.[134]

11.24 The PRA has considered these aspects in relation to the proposals and considers competition and competitiveness to be of particular relevance.

11.25 The PRA has considered competition in its proposed proportionate implementation of the CRD V requirements, which focuses on ensuring the burden placed on firms is commensurate with any risks the PRA has identified to its objectives. The implementation of the CRD V requirement for the approval of certain holding companies would impose costs that could have a competition impact for the affected firms, and hence competition in the sector. However, a proportionate applications process will limit the costs imposed on firms and hence the likelihood of any impact on competition.

11.26 The PRA considers that the UK's competitiveness will be supported by an appropriate and proportionate implementation of CRD V requirements. The prudential measures addressing financial stability would help maintain a robust and resilient UK financial system, supporting London's position as a leading international financial centre and the UK's attractiveness to internationally active financial institutions.

Equality and diversity

11.27 The PRA considers that the proposals do not give rise to equality and diversity implications.

134 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.

Appendices

Appendix 1: Draft Rules instruments available at: https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2020/cp1720app1.pdf

Appendix 2: Draft Rules instruments including EU Exit instruments available at: https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2020/cp1720app2.pdf

Appendix 3: Draft Statements of Policy and Supervisory Statements available at: https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2020/cp1720app3.pdf

Appendix 4: Draft Capital Buffers And Pillar 2a Model Voluntary Requirement (VREQ): https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2020/cp1720app4.pdf

Appendix 5: Holding companies approval: Indicative information requirements: https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2020/cp1720app5.pdf