



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Supervisory Statement | SS[xx]/15

The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)

April 2015

The changes below should be made to the SS[xx]/15 'The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)' in Appendix 2 to CP1/15.

Underlining indicates new text and striking through indicates deleted text. Paragraphs will be renumbered when the final supervisory statement is published.

1 Introduction

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1.4 Chapter 3: *Stress testing, scenario analysis and capital planning* sets out the PRA's expectations of firms in relation to stress testing, scenario analysis and capital planning, and the requirements set out in Chapter 12 of the Internal Capital Adequacy Assessment part of the PRA Rulebook.

1.5 Chapter 4: *Reverse stress testing* sets out the PRA's expectations of firms in relation to reverse stress testing, and the requirements set out in Chapter 15 of the Internal Capital Adequacy Assessment Part of the PRA Rulebook.

1.65 Chapter 54: *The SREP* sets out the factors that the PRA takes into consideration to assess a firm's ICAAP. It explains the setting of Individual Capital Guidance (ICG) and the PRA buffer, the consequences in the event a firm fails to meet ICG or uses the PRA buffer, and that the PRA is collecting data to support the SREP. It also sets out the factors that the PRA takes into consideration to assess a firm's reverse stress-testing approach including the PRA response to weaknesses in the process.

1.67 This supervisory statement should be read in conjunction with the statement of policy *The PRA's methodologies for setting Pillar 2 capital*.

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3.21 In identifying adverse circumstances and events in accordance with Internal Capital Adequacy Assessment 12.1, a firm should consider the results of any reverse stress testing conducted in accordance with ~~SYSC 20~~ Chapter 15 of the Internal Capital Adequacy Assessment Part of the PRA Rulebook. Reverse stress testing may be expected to provide useful information about the firm's vulnerabilities for the purpose of meeting the firm's obligations under Internal Capital Adequacy Assessment 12.1. In addition, such a comparison may help a firm to assess the sensitivity of its financial position to different stress calibrations.

4 Reverse stress testing

4.1 Reverse stress testing is a risk management tool used to increase a firm's awareness of its business model vulnerabilities. Firms in scope of Chapter 15 of the Internal Capital Adequacy Assessment Part of the PRA Rulebook must carry out reverse stress testing in accordance with Chapter 15 of that Part. This includes requirements on the firm to reverse stress test its business plan; that is, to carry out stress tests and scenario analyses that test its business plan to failure.

4.2 Business plan failure in the context of reverse stress testing should be understood as the point at which the market loses confidence in a firm and, as a result, the firm is no longer able to carry out its business activities. Examples of this would be the point at which all or a substantial portion of the firm's counterparties are unwilling to continue transacting with it or seek to terminate their contracts, or the point at which the firm's existing shareholders are unwilling to provide new capital. Such a point may be reached well before the firm's financial resources are exhausted.

4.3 The PRA may request a firm to quantify the level of financial resources which, in the firm's view, would place it in a situation of business failure should the identified adverse circumstances crystallise.

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

4.5 Reverse stress testing should be appropriate to the nature, size and complexity of the firm's business and of the risks it bears. Where reverse stress testing reveals that a firm's risk of business failure is unacceptably high, the firm should devise realistic measures to prevent or mitigate the risk of business failure, taking into account the time that the firm would have to react to these events and implement those measures. As part of these measures, a firm should consider if changes to its business plan are appropriate. These measures, including any changes to the firm's business plan, should be documented as part of the results referred to in rule 15.4 of the Internal Capital Adequacy Assessment Part of the PRA Rulebook.

4.6 In carrying out its reverse stress testing, a firm should consider scenarios in which the failure of one or more of its major counterparties or a significant market disruption arising from the failure of a major market participant, whether or not combined, would cause the firm's business to fail.

4.7 Firms may choose to use reverse stress testing as a starting point for their recovery plan scenarios.

5 4 The SREP

5 4.1 The SREP is a process by which the PRA, taking into account the nature, scale and complexity of a firm's activities, reviews and evaluates the:

- arrangements, strategies, processes and mechanisms implemented by a firm to comply with its regulatory requirements laid down in PRA rules and the CRR;
- risks to which the firm is or might be exposed;

- risks that the firm poses to the financial system; and
- further risks revealed by stress testing.

5.4.2 As part of the SREP, the PRA will review the firm's ICAAP and have regard to the risks outlined in the overall Pillar 2 rule in Internal Capital Adequacy Assessment 3.1, the firm's vulnerabilities under reverse stress testing, the governance arrangements of firms, its corporate culture and values, and the ability of members of the management body to perform their duties. The degree of involvement of the management body of the firm will be taken into account by the PRA when assessing the ICAAP, as will the appropriateness of the internal processes and systems for supporting and producing the ICAAP.

5.4.3 When the PRA reviews an ICAAP as part of the SREP, it does so as part of the process of determining whether all of the material risks have been identified and that the amount and quality of capital identified by the firm is sufficient to cover the nature and level of the risks to which it is or might be exposed.

5.4 The PRA may request a firm to submit the design and results of its reverse stress tests and any subsequent updates as part of its risk assessment.

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5.9 ~~4.8~~ On the basis of the SREP, the PRA will determine whether the arrangements implemented by a firm and the capital held by it provide sound management and adequate coverage of its risks. If necessary, the PRA will require the firm to take appropriate actions or steps at an early stage to address any future potential failure to meet its prudential regulatory requirements, or to prevent or mitigate the risk of business failure revealed by reverse stress testing. The PRA recognises that not every business failure is driven by lack of financial resources and will take this into account when reviewing a firm's reverse stress-test design and results.

5.10 ~~4.9~~ There are two main areas that the PRA considers when assessing a firm's capital adequacy under ~~conducting~~ a SREP: (i) risks to the firm which are either not captured, or not fully captured, under the CRR (eg IRRBB and concentration risk); and (ii) risks to which the firm may become exposed over a forward-looking planning horizon (eg due to changes to the economic environment). The PRA refers to the first area as Pillar 2A and the second as Pillar 2B.