

Bank of England PRA

The Internal Capital Adequacy Assessment (ICAAP) and Supervisory Review and Evaluation Process (SREP) for Small Domestic Deposit Takers (SDDTs)

Comparison with SS31/15

September 2024

Draft for consultation



The PRA has completed this comparison document on a best-efforts basis, to show the broad way in which the policy that applies currently to firms that are eligible to be SDDTs would change as a result of the proposals in CP7/24. This document does not fully represent the proposed policy. The full policy proposal can be found in The Internal Capital Adequacy Assessment (ICAAP) and Supervisory Review and Evaluation Process (SREP) for Small Domestic Deposit Takers (SDDTs).

1- Introduction

1.1- This supervisory statement is relevant to ~~all PRA-regulated banks, building societies, designated investment firms~~ Small Domestic Deposit Takers (SDDTs) and ~~all PRA-approved or PRA-designated holding companies~~ SDDT consolidation entities,¹ and replaces PRA supervisory statement (SS)31/15 – The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Statement (SS) 5/13² and SS6/13.³ 4.1.2 Review and Evaluation Process (SREP)⁵ for SDDTs and SDDT consolidation entities.⁶ It provides further detail in relation to the high-level expectations outlined in ‘The Prudential Regulation Authority’s approach to banking supervision’.⁷

1.3-2 Chapter 2: ‘Expectations of ~~firms~~ SDDTs undertaking an ICAAP’ sets out the expectations the PRA has in relation to the Internal Capital Adequacy Assessment Process (ICAAP) and the requirements set out in the Internal Capital Adequacy Assessment (ICAA) Part of the PRA Rulebook. It sets out the PRA’s expectations regarding ~~firms’~~ SDDTs’ coverage and treatment of interest rate risk in the non-trading book (more commonly referred to as interest rate risk in the banking book or IRRBB), ~~market risk, group risk,~~ operational risk, pension obligation risk, market risk, group risk and foreign currency lending to unhedged retail and SME borrowers. It also provides additional detail on data that ~~firms~~ SDDTs are required or expected to submit with their ICAAP document or otherwise as applicable.

1.4-3 Chapter 3: ‘Stress testing, scenario analysis and capital planning’ sets out the PRA’s expectations of ~~firms~~ SDDTs in relation to stress testing, scenario analysis and capital

¹ The full definition of an SDDT and an SDDT consolidation entity, including the SDDT and SDDT consolidation entity criteria, are set out in the SDDT Regime – General Application of the PRA Rulebook.

² PRA Supervisory Statement 5/13, ‘The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)’, December 2013: <https://www.bankofengland.co.uk/prudential-regulation/publication/2013/the-internal-capital-adequacy-assessment-process-and-supervisory-review-ss>.

³ PRA Supervisory Statement 6/13, ‘Stress testing, scenario analysis and capital planning’, December 2013: <https://www.bankofengland.co.uk/prudential-regulation/publication/2013/the-internal-capital-adequacy-assessment-process-and-supervisory-review-ss>.

⁴ On 1 February 2017, this SS was updated – see annex for full details.

⁵ July 2015: SS31/15 - The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP) | Bank of England.

⁶ For ease of reading, any references to SDDT(s) hereafter in this SS should be treated as applicable to both SDDTs and SDDT consolidation entities, unless stated otherwise.

⁷ June 2014:

<https://www.bankofengland.co.uk/publications/Documents/praapproach/bankingappr1406.pdf>, July 2023: The Prudential Regulation Authority’s approach to banking supervision (bankofengland.co.uk).

planning, and the requirements set out in Chapter 12 of the ~~Internal Capital Adequacy Assessment~~ICAA Part of the PRA Rulebook.

1.5-4 Chapter 4: ‘Reverse stress testing’ sets out the PRA’s ~~expectations of firms in relation proposed approach~~ to amending reverse stress testing, ~~and the~~ requirements for SDDTs, set out in Chapter 15 of the ~~Internal Capital Adequacy Assessment~~ ICAA Part of the PRA Rulebook.

1.6-5 Chapter 5: ‘The C-SREP’ sets out the factors that the PRA takes into consideration to assess ~~a firm’s~~an SDDT’s ICAAP. It explains the setting of ~~firm~~SDDT specific capital requirements and the ~~PRA buffer~~Single Capital Buffer (set under the PRA’s Pillar 2B framework), the consequences in the event ~~a firm~~an SDDT fails to meet its Total Capital Requirement (TCR)⁸ or uses the ~~PRA buffer~~Single Capital Buffer, and disclosure. ~~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.~~

1.7-6 This supervisory statement should be read in conjunction with the ~~Statement~~draft statement of ~~Policy~~‘policy (SoP)’ The PRA’s methodologies for setting Pillar 2 ~~capital~~⁹. ~~For ring-fenced bodies (RFBs), as defined in the Financial Services and Markets Act 2000 (FSMA), section 142A, and banking groups containing RFBs, this statement should be read alongside SS8/16, ‘Ring-fenced Bodies (RFBs)’ capital for Small Domestic Deposit Takers (SDDTs).~~¹⁰

⁸ -Pillar 1 plus Pillar 2A capital requirements-.

⁹ — <https://www.bankofengland.co.uk/pru/Pages/publications/sop/2017/p2methodologiesupdate.aspx>.

¹⁰ — February 2017: <https://www.bankofengland.co.uk/prudential-regulation/publication/2016/ring-fenced-bodies-ss>.

2- Expectations of firms SDDTs undertaking an ICAAP

2.1 ~~A firm~~An SDDT must carry out an ICAAP in accordance with the PRA's ICAA rules. These include requirements on the firm SDDT to assess on an ongoing basis the amounts, types, and distribution of capital that it considers adequate to cover the level and nature of the risks to which it is or might be exposed. This assessment should cover the major sources of risks to the firm's SDDT's ability to meet its liabilities as they fall due, and should incorporate stress testing and scenario analysis. If ~~a firm~~an SDDT is merely attempting to replicate the PRA's own methodologies, it will not be carrying out its own assessment in accordance with the ICAA rules.

2.2 The ICAAP should be documented and updated in full at least every two years by SDDTs; annually by the firm, for SDDTs that are new and growing banks subject to SS3/21¹¹; or more frequently in the case of a material change in circumstance or if changes in the business, strategy, nature or scale of its activities or operational environment suggest that the current level of financial resources is no longer adequate.-

2.2.3 The PRA expects firms, in the first instance, to take responsibility for ensuring that the capital they have is adequate. As stated above, the ICAAP should be documented and updated more frequently than every two years in the case of a material change in circumstance. This includes but is not limited to: material balance sheet growth, change in business model (eg focus on higher loan to value (LTV) lending, change in product offering), or material changes to the operational environment such as changes to market conditions or interest rates. In addition, to ensure that SDDT resilience is maintained with the reduction in the expected frequency of the ICAAP update, the PRA may request an annual update from an SDDT if necessary. For example, if an SDDT's ICAAP is of poor quality, supervisors could ask the SDDT to remediate issues in the next year, and evidence this through submission of an updated ICAAP document.

2.4 However, the PRA expects SDDTs to update and document their Pillar 2A and Pillar 2B assessments on an annual basis (or more frequently for the reasons noted in 2.2 above).

2.5 The PRA expects SDDTs, in the first instance, to take responsibility for ensuring that the capital they maintain is adequate given their balance sheet risks, with the ICAAP being an integral part of meeting this expectation. The PRA expects an ICAAP to be the responsibility of a firm's an SDDT's management body, that it is approved by the management body, and that it is used as an integral part of the firm's SDDT's management process and decision

¹¹ April 2021: SS3/21 - Non-systemic UK banks: The Prudential Regulation Authority's approach to new and growing banks | Bank of England

making. The processes and systems used to produce the ICAAP document should ensure that the assessment of the adequacy of a firm's SDDT's financial resources is reported to its management body as often as is necessary.

2.3-6 The ICAAP, and internal processes and systems supporting it, should be proportionate to the nature, scale and complexity of the activities of a firm's SDDT, as set out in Internal Capital Adequacy Assessment ICA 3.3 in the PRA's Rulebook. Where a firm's SDDT has identified risks as not being material, it should be able to provide evidence of the assessment process that determined this conclusion and discuss why that conclusion has been reached.

2.4-7 Liquidity risk should also be assessed, including in relation to potential losses arising from the liquidation of assets and increases in the cost of funding during periods of stress. The requirements in relation to liquidity risk may be found in PS11/15,¹² ¹³ and SS24/15.¹⁴ The PRA considers SDDTs should be able to draw on work done in the Internal Liquidity Adequacy Assessment Process (ILAAP) in their assessment of liquidity risk.

2.5-8 If the ILAAP highlights liquidity concerns, the PRA would expect the ICAAP to build on this analysis to consider how liquidity risks could lead to potential losses and capital adequacy implications. If there are no such concerns, SDDTs would not be expected to do anything more.

2.9 As set out in further detail below, the PRA also expects firms SDDTs to develop a framework for stress testing, scenario analysis and capital management that captures the full range of risks to which they are exposed and enables these risks to be assessed against a range of plausible yet severe scenarios. The ICAAP document should outline how stress testing supports capital planning for the firm SDDT.

2.6-10 Where a firm's SDDT uses a model to aid its assessment of the level of capital adequacy, it should be appropriately conservative and should contribute to prudent risk management and measurement. The firm SDDT should expect the PRA to investigate the structure, parameterisation and governance of the model, and the PRA will seek reassurance that the firm SDDT understands the attributes, outputs and limitations of the model, and that it has the appropriate skills and expertise to operate, maintain and develop the model.

¹² PRA Policy Statement PS11/15, 'CRD IV: Liquidity', June 2015: <https://www.bankofengland.co.uk/prudential-regulation/publication/2014/crd-iv-liquidity>.

¹³ PRA policy statement PS11/15, 'CRD IV: Liquidity', June 2015:

<https://www.bankofengland.co.uk/prudential-regulation/publication/2014/crd-iv-liquidity>.

¹⁴ PRA supervisory statement SS24/15, 'The PRA's approach to supervising liquidity and funding risks', June 2015: SS24/15 - The PRA's approach to supervising liquidity and funding risks | Bank of England

Credit risk

2.11 The PRA expects an SDDT which meets any of the following criteria¹⁵ to provide in their ICAAP document a detailed assessment of the capital needed to support their credit risk exposures and propose a Pillar 2A credit risk add-on if appropriate:

- new and growing banks as defined in **SS3/21 – Non-systemic UK banks: The PRA's approach to new and growing banks**;
- SDDTs predominantly engaged in unsecured retail lending; or
- SDDTs engaged in other higher risk lending (eg sub-prime lending) where additional capital would be potentially required to ensure the SDDT is capitalised appropriately.

2.12 The PRA expects an SDDT meeting the above criteria to make use of credit scenarios as the core methodology to conduct this detailed assessment. The PRA expects that SDDTs should design their own credit scenarios for this purpose, which should be high-severity tail events, over a 12-month horizon, with particular focus on how these events may result in credit losses for higher-risk lending which is not captured under Pillar 1. SDDTs should ensure their own credit scenarios are more severe than the non-cyclical stress test scenarios published by the PRA (please see paragraph 3.16-3.20 for more details about these scenarios).

2.13 The PRA expects an SDDT meeting the criteria in paragraph 2.11 above to detail its credit scenario analysis in its ICAAP, and that these details should cover the following:

- a clear description of the type, characteristics, and severity of stress that its credit portfolio is vulnerable to;
- a clear description of the way in which the SDDT's credit portfolio may be impacted by the range of macroeconomic variables set out in the scenario; and
- a clear description of the steps taken to derive the figures presented.

2.14 The SDDT should ensure accuracy and consistency in these descriptions (eg that figures are consistent with returns submitted to the PRA).

2.15 As an alternative to using credit scenario analysis, an SDDT meeting the criteria in paragraph 2.11 above may conduct the assessment using proxy internal ratings based

¹⁵ In cases where an SDDT falling outside the criteria but considers it would be appropriate for the SDDT to conduct this assessment, the PRA expects an SDDT to include the assessment in its ICAAP based on the core methodology and expectations set out in 2.12 – 2.15. This is in line with the ICAA Part of the PRA Rulebook that SDDTs must assess and maintain capital they consider adequate to cover all the risks and the PRA's expectation that SDDTs to take responsibility for ensuring that the capital requirements they have are adequate.

models¹⁶ and detail these assessments in their ICAAP. However, given concerns on the potential over-reliance on non-approved models, the PRA expects this option would be limited to exceptional cases. The PRA also expects SDDTs to take responsibility to ensure the models used to assess capital requirements are robust and comprehensive.

2.16 Where an SDDT meets the criteria in paragraph 2.11, but does not provide an assessment of credit risk in its ICAAP along the lines set out above, the PRA will assess the SDDT's Pillar 2A credit risk add-on based on sufficiently conservative assumptions to ensure capital requirements cover risks the SDDT may be exposed to in accordance with paragraph 2.5 of the draft SoP 'The PRA's methodologies for setting Pillar 2 capital for Small Domestic Deposit Takers (SDDTs).'

Credit risk mitigation: guarantees qualifying as unfunded credit protection

2.6A-17 For firmsSDDTs using the Standardised Approach for credit risk, GRR Article 235(1)the Credit Risk Mitigation Part of the PRA Rulebook allows firmsSDDTs to recognise guarantees qualifying as unfunded credit protection under Part Three, Title II, Chapter 4 (Credit risk mitigation) of the GRR by substituting the risk weight of an obligor with the risk weight of a guarantor, for the protected amount of the exposure. Firms (ie the risk weight substitution method). SDDTs are expected to assess whether a full substitution of the risk weight of the guarantor is warranted or not. As part of this assessment, firmsSDDTs should consider the risk that, notwithstanding the fulfilment of eligibility criteria under Pillar 1 for qualifying guarantees, the credit protection could in practice become ineffective due to any reason other than the default of the guarantor and evidence this assessment within its ICAAP document. As part of this consideration, the PRA expects firmsSDDTs to consider in particular the:

- risk, if any, that in practice the guarantor would seek to reduce or be released from liability under the guarantee, for example through lengthy settlement or disputes processes; and
- operational risk that the firmSDDT may breach its obligations under the terms of the guarantee in a manner that might entitle the guarantor not to pay out.

2.6B-18 Where firmsSDDTs assess that a full substitution is not prudent, the PRA expects firmsSDDTs to consider whether a Pillar 2A add-on is appropriate.

¹⁶ An example of a proxy IRB model may include a firm creating its own proxy internal ratings based modelling to estimate the equivalent risk-weight based on historical performance of its own credit portfolios.

Operational risk

2.19 As set out in ICAA 10.1 in the PRA's rulebook, SDDTs must implement policies and processes to evaluate and manage their exposure to operational risk, and to cover low-frequency and high-severity events.

2.20 As part of meeting this requirement, the PRA expects SDDTs to provide in their ICAAP document their operational risk scenario analysis, information on their management of operational risk and any available data the SDDT has on recent loss events and/or any expected losses in the next year.

2.21 The PRA expects that the scenario analysis should:

- explore low frequency and high-severity events;
- show the frequency – how often the event is estimated to occur - and severity of the event – the estimated amount of operational loss;
- represent the key risks faced by the SDDT;
- be informed by the SDDT's risk register;
- be informed by bottom-up and top-down engagement within the SDDT;
- cover the seven Basel operational risk event type categories, as set out in the PRA rulebook, which include internal fraud, external fraud, employment practices and workplace safety, clients, products and business practices, damage to physical assets, business disruption and system failures;
- include the frequency and severity of the event before and after risk mitigations and controls; and
- be a part of the SDDT's operational risk management framework and inform the SDDT's risk mitigations and controls.

2.22 The PRA expects SDDTs to explore low-frequency and high severity events. The PRA expects SDDTs to tailor the frequency and severity of the scenarios to ensure they are aligned to the risks to which they are most exposed. The PRA considers that asking SDDTs to estimate losses for each scenario is important so they can understand the scale of risks they may be exposed to, to inform their risk management, and to give the PRA information on the effectiveness of risk mitigations and controls. The PRA considers that a proportionate way for SDDTs to explore low-frequency and high severity events is to combine individual events together. For example, SDDTs could combine individual events such as a 1-in-40

year event exploring one Basel event type and a 1-in-25 year event exploring another Basel event type.

2.23 Business continuity plans are also a key component of operational risk management. Plans should include consideration of:

- resource requirements such as people, systems and other assets, and arrangements for obtaining these resources;
- the recovery priorities of the SDDT's operations;
- communication arrangements for internal and external concerned parties (including the PRA, clients and the media);
- escalation and invocation plans that outline the processes for implementing the business continuity plans, together with relevant contact information;
- processes to validate the integrity of information affected by the disruption; and
- regular stress testing of the business continuity plan in an appropriate and proportionate manner.

2.24 The PRA will use the SDDT's ICAAP assessment along with supervisory judgement to set the Pillar 2A requirement in line with the draft SoP 'The PRA's methodologies for setting Pillar 2 capital for Small Domestic Deposit Takers (SDDTs).'

Credit concentration risk

2.25 An SDDT should ensure that its internal risk measurement system allows it to address and control all material sources of credit concentration risk in compliance with ICAA 6.1.

2.26 For sector concentration risk, the PRA expects SDDTs with significant wholesale exposures to reflect the concentration risks from these exposures in their stress testing, in accordance with Chapter 3 - Stress testing, scenario analysis and capital planning.

2.27 The PRA's approach to setting Pillar 2A capital requirements for credit concentration risk, including calculating add-ons and reviewing single-name concentrations, is outlined in Chapter 4 of the draft SoP 'The PRA's methodologies for setting Pillar 2 capital for Small Domestic Deposit Takers (SDDTs).

IRRBB

2.7-28 All ~~firms~~**SDDTs** must have appropriate systems and processes, proportionate to the nature, scale and complexity of their business, to identify, evaluate and manage IRRBB.

~~2.7A-29~~ The PRA expects ~~a firm's~~ SDDT to include small trading book business (as identified under Article 94 Derogation for Small Trading Book of the Trading Book (CRR) part of the PRA Rulebook) as part of its identification, evaluation and management of IRRBB unless its interest rate risk is captured in another risk measure.

Supervisory Actions

~~2.7B30~~ ~~A firm~~ An SDDT must, under ~~Internal Capital Adequacy Assessment~~ ICA 9.4A, immediately notify the PRA if its economic value of equity (EVE) would decline by more than 15% of its Tier 1 capital as a result of the application of the interest rate scenarios in ~~Internal Capital Adequacy Assessment Rule 9.7~~, ICA 9.7. In that case, it shall be considered an outlier firm. The PRA will review each outlier firm to determine whether the PRA considers that the ~~firm's~~ SDDT has excessive IRRBB or inadequate management of IRRBB. The PRA may also conduct such a review for firms that are not outlier firms.

General Requirements on IRRBB

~~2.7C32~~ An SDDT's management body should oversee and approve the SDDT's risk appetite and framework for managing IRRBB. This framework should be consistent across consolidated and sub-consolidated entities (if relevant). The risk appetite should be expressed in terms of the risk to economic value and the risk to earnings.

2.31 Where the review in ~~2.7B-30~~ leads the PRA to consider that ~~a firm's~~ an SDDT's risk management of IRRBB is inadequate for the purposes of its obligations in the PRA Rulebook, or that the risk is excessive relative to the ~~firm's~~ SDDT's capital or earnings, the PRA is likely to expect the ~~firm's~~ SDDT to take one or more of the following actions:

- (i) take steps to reduce its IRRBB exposures;
- (ii) hold additional capital for its IRRBB;
- (iii) implement constraints to internal risk parameters; or
- (iv) make other corrective actions to address deficiencies in its models or risk management framework.

General Requirements on IRRBB

~~2.8~~ ~~[deleted]~~

~~2.8A~~ ~~A firm's management body should oversee and approve the firm's risk appetite and framework for managing IRRBB. This framework should be consistent across consolidated and sub-consolidated entities. The risk appetite should be expressed in terms of the risk to economic value and the risk to earnings.~~

~~2.8B33~~ The systems and processes should allow the ~~firm's~~ SDDT to:

- (i) identify and quantify the major sources of IRRBB exposures;

- (ii) retrieve accurate information in a timely manner;
- (iii) compute economic value and earnings measures of IRRBB for different scenarios;
- (iv) incorporate constraints specified by the PRA on the firm's SDDT's internal risk parameter estimates;
- (v) compare risk figures over different periods (eg by monitoring the impact of changes to the way the repricing dates are determined for the purpose of calculating IRRBB);
- (vi) assess all material cash flows from relevant interest rate sensitive instruments, including non-performing exposures (net of provisions), interest rate derivatives and off-balance sheet items such as interest rate sensitive loan commitments;
- (vii) measure the exposure and sensitivity of its activities, if material, to gap risk, yield curve risk, basis risk and risks arising from embedded optionality (eg pipeline risk and prepayment risk) as well as changes in assumptions (eg those relating to customer behaviour);
- (viii) consider whether a purely static analysis of the impact on its current portfolio of a given shock or shocks should be supplemented by a more dynamic simulation approach;
- (ix) model scenarios in which different interest rate paths are computed and in which some of the assumptions (eg about behaviour, contribution to risk and balance sheet size and composition) are themselves functions of interest rate levels; and
- (x) measure the exposure and sensitivity of its fair value exposures to changes in value resulting from yield curve and basis risk.

2.8C-34 The PRA expects a firm's SDDT to set and apply policy limits for IRRBB that are consistent with the firm's SDDT's risk appetite. When setting policy limits, a firm's SDDT should ensure that:

- (i) policy limits are appropriate to the nature, size, complexity and capital adequacy of the firm's SDDT;
- (ii) policy limits are reviewed at least annually; and
- (iii) gap risk, basis risk and positions with explicit and embedded options are considered in the setting of policy limits where the firm's SDDT has significant exposures to these risks and positions.

2.8D-35 The PRA expects a firm's SDDT's management body to have the appropriate expertise to understand:

- (i) the nature and the level of IRRBB;
- (ii) the implications of a firm's an SDDT's strategies for managing IRRBB, including the potential linkages with and impact on market, liquidity, credit and operational risk; and
- (iii) the most significant behavioural and modelling assumptions and their implications, including for hedging strategies.

~~2.8E36~~ A firm's An SDDT's management body may delegate the management and monitoring of IRRBB to senior management, the firm's SDDT's Asset and Liability Committee or to one or more individuals with sufficient expertise. The relevant delegate(s) should include members with clear lines of authority over the units responsible for establishing and managing positions.

~~2.8F37~~ A firm's An SDDT's management body should regularly review timely and sufficient information for assessing the performance of its delegates in monitoring and controlling IRRBB and credit spread risk in the non-trading book in accordance with its framework and its risk appetite.

~~2.8G38~~ A firm's An SDDT's management body or its delegates should establish and maintain an adequate risk management framework for IRRBB. The PRA expects that the framework should include measures to establish, apply and maintain at least the following:

- (i) appropriate limits on IRRBB;
- (ii) procedures for ensuring compliance with the limits in (i);
- (iii) an approvals process for exceptions from the limits in (i);
- (iv) adequate systems, standards and controls for measuring IRRBB;
- (v) standards for measuring IRRBB, valuing positions and measuring performance;
- (vi) an appropriate reporting and review process for IRRBB;
- (vii) adequate internal controls and management information systems for IRRBB;
- (viii) an adequate approval process for approving major hedging or risk-taking initiatives prior to implementation;
- (ix) appropriate governance processes for ensuring the adequacy of the models;
- (x) a formal policy process for the validation of IRRBB measurement methods and assessment of corresponding model risk; and

- (xi) a process to regularly measure IRRBB based on outcomes of economic value and earnings-based measures.

~~2.8H39~~ ~~A firm's~~ An SDDT's management body or its delegates should approve major hedging or risk-taking initiatives relating to IRRBB in advance of their implementation.

~~2.8I40~~ ~~A firm~~ An SDDT should ensure that the functions responsible for identification, measurement, monitoring and control of IRRBB are, where appropriate to its nature, size and complexity as well as business activities and overall risk profile, sufficiently independent from risk-taking functions and report directly to the management body or its delegates.

~~2.8J41~~ ~~A firm~~ An SDDT should review and evaluate the effectiveness of its framework on a regular basis, and at least annually. Where appropriate to its nature, size and complexity as well as business activities and overall risk profile, the reviews and evaluations should be carried out by individuals that are sufficiently independent of the individuals responsible for designing and implementing the framework.

~~2.8K42~~ ~~A firm~~ An SDDT should have its framework reviewed by an independent internal auditing function on a regular basis.

Measurement of IRRBB

~~2.9~~ ~~[Moved to 2.11A]~~

~~2.9A43~~ ~~A firm~~ An SDDT should ensure that the internal risk measurement system used to comply with the obligation in the PRA Rulebook capture all material sources of IRRBB exposures. If the PRA determines the internal risk measurement systems of ~~a firm~~ An SDDT inadequate in risk capture or for other reasons, the ~~firm~~ SDDT should take such steps as the PRA may direct or require, including use of the Basel Committee on Banking Supervision's standardised framework under ~~Internal Capital Adequacy Assessment~~ ICA 9.13 when performing the evaluation under ~~Internal Capital Adequacy Assessment~~ ICA 9.2 and 9.4A.

~~2.9B 44~~ Under ~~Internal Capital Adequacy Assessment~~ ICA 9.4A, ~~a firm~~ An SDDT is required to calculate the impact of the change in interest rates described in ~~Internal Capital Adequacy Assessment~~ ICA 9.7 on the economic value of equity of ~~a firm's~~ An SDDT's non-trading book activities. ~~A firm~~ An SDDT should perform this calculation regularly, and at least quarterly. When performing the calculation, ~~a firm~~ An SDDT should, where appropriate to its nature, size and complexity as well as business activities and overall risk profile, apply the following principles:

- (i) the calculation should exclude the ~~firm's~~ SDDT's own equity;
- (ii) the change in EVE (~~A~~ DEVE) should be computed with the assumptions of a run-off balance sheet;

- (iii) a maturity-dependent post-shock interest rate floor should be applied for each currency starting with -100 basis points for immediate maturities and increase by 5 basis points per year, eventually reaching 0% for maturities of 20 years and more (where the observed rates are lower than the current lower reference rate of -100 basis points, a firm's SDDT should apply the lower observed rates);
- (iv) when calculating the aggregate AD EVE for each interest rate shock scenario, a firm's SDDT should add together any negative and positive AD EVE occurring in each currency and any positive changes should be weighted by a factor of 50%;
- (v) the automatic and behavioural options, including the assumptions identified in 2.9K2.53 should be reflected in the calculation;
- (vi) the assumed behavioural repricing date for retail and non-financial wholesale deposits without any specific repricing dates (non-maturing deposits) should be constrained to a maximum average of 5 years for each individual currency;
- (vii) the calculation should include all cash flows from all interest rate-sensitive assets (assets which are not deducted from Common Equity Tier 1 capital and which exclude (i) fixed assets such as real estate or intangible assets as well as (ii) equity exposures in the non-trading book), liabilities and off-balance sheet items in the non-trading book in the computation of their exposure; and
- (viii) if commercial margins and other spread components are included in the cash flows calculated for measurement of IRRBB, the firm's SDDT should also include commercial margins and other spread components in the rates used for discounting those cash flows.

2.9C-45 Alongside the requirement to monitor and evaluate the potential impact of changes in interest rates on economic value, the PRA expects firms to monitor and evaluate the potential impact on earnings volatility. As appropriate to its nature, size and complexity as well as business activities and overall risk profile, a firm's SDDT should include in its evaluation:

- (i) assessment based on an appropriate timeframe of three to five years;
- (ii) the firm's SDDT's forward-looking view of product volumes and pricing, based on its proposed business model during the scenario, and the projected path of interest rates;
- (iii) careful consideration should be given to how any resulting volatility is managed;
- (iv) consideration on the effects on its cash flow (ie interest income and expenses), and for large or more SDDTs with complex firms IRRBB exposures, the projected cash flow under different interest rate scenarios;

- (v) consideration on the effects of the market value changes of interest rate sensitive instruments; and
- (vi) the firm's SDDT's careful consideration to managing any resulting volatility on its' earnings.

2.9D-46 The models used to comply with the obligation in the PRA Rulebook should incorporate a wide and appropriately prudent range of interest rate shock and stress scenarios by currency. Those scenarios should include:

- (i) interest rate shock scenarios selected by the firm SDDT reflecting its risk profile in accordance with Internal Capital Adequacy Assessment ICAA 9.2;
- (ii) historical and hypothetical interest rate stress scenarios;
- (iii) the interest rate shock scenarios in Internal Capital Adequacy Assessment ICAA 9.7; and
- (iv) any additional interest rate shock scenarios required by the PRA.

2.9E-47 For the range of interest rate shock scenarios, a firm's SDDT should ensure:

- (i) they encompass a wide range of severe and plausible interest rate shock scenarios relevant to the firm's SDDT's material sources of IRRBB;
- (ii) where relevant to the firm's SDDT's own material sources of IRRBB, the scenarios consider gap risk, basis risk, and option risk (including sensitivity to interest rate movements); concentrated risks; and interaction with other risks;
- (iii) the scenarios consider vulnerability to reduced economic value or earnings under stressful market conditions – including the breakdown of key assumptions;
- (iv) they assess the effect of adverse changes in the spreads of new assets/liabilities replacing those assets/liabilities maturing over the horizon of the forecast on its earnings-based measures; and
- (v) the scenarios consider potential changes in the firm's SDDT's non-trading book activities.

2.9F-48 In addition to considering the range of interest rate shock scenarios in 2.9E47 for the purpose of ongoing management, a firm's SDDT should also use other larger and more extreme shifts and changes in interest rates for testing vulnerabilities under stressed condition.

~~2.9G49~~ Under ~~Internal Capital Adequacy Assessment~~ICAA 9.12, ~~a firm~~an SDDT should either determine the interest rate shock scenarios for material positions in currencies not listed in ~~Internal Capital Adequacy Assessment~~ICAA 9.11 by considering the following, or use interest rate shock scenarios produced by a third party that are consistent with the following:

- (i) a sufficiently long time-series of daily 'risk-free' interest rates for each currency for relevant maturities;
- (ii) the baseline global shock parameters on the average interest rate, which comprises: ~~(ia)~~ 60% for parallel shocks; ~~(ib)~~ 85% for short rate shocks; and ~~(ic)~~ 40% for long rate shocks; and
- (iii) a floor of 100 basis points and caps of: ~~(ia)~~ 500 basis points for the short-term; ~~(ib)~~ 400 basis points for the parallel; and ~~(ic)~~ 300 basis points for the long-term interest rate shock scenario.

~~2.9H50~~—~~A firm~~ An SDDT should develop and implement an effective stress testing framework that:

- (i) is commensurate with its nature, size and complexity as well as business activities and overall risk profile;
- (ii) is performed regularly, at least annually and more frequently in times of increased interest rate volatility and increased IRRBB levels;
- (iii) where relevant, stress testing should incorporate the risks identified in ~~2.9E2.47~~2.9E2.47;
- (iv) includes relevant qualitative and quantitative reverse stress tests in order to:
 - a. identify interest rate scenarios that could significantly threaten the ~~firm's~~SDDT's capital and earnings; and
 - b. reveal vulnerabilities arising from the ~~firm's~~SDDT's hedging strategies and the behavioural reactions of its customers.

~~2.9I51~~—~~A firm~~ An SDDT should reflect in its risk management framework how an instrument's actual maturity or repricing behaviour may vary from the instrument's contractual terms because of behavioural optionalities.

~~2.9J52~~—~~A firm~~ An SDDT should establish and maintain documentation setting out the key behavioural assumptions and modelling assumptions it uses in measuring IRRBB.

~~2.9K53~~ For the documentation of behavioural and modelling assumptions, ~~a firm~~an SDDT should set out:

- (i) expectations for the exercise of explicit and embedded interest rate options by both the ~~firm~~SDDT and its clients under specific interest rate shock and stress scenarios;
- (ii) treatment of balances and interest flows arising from non-maturity deposits;
- (iii) the treatment of fixed rate loan commitments;
- (iv) the treatment of fixed term deposits with risk of early redemption;
- (v) treatment of own equity in economic value measures;
- (vi) the implications of accounting practices for IRRBB; and
- (vii) how the assumptions in ~~2.9J~~2.52 may affect the ~~firm's~~SDDT's hedging strategies.

~~2.9L~~54 A ~~firm~~ An SDDT should review significant assumptions at least annually, and when market conditions change significantly. These assumptions should be aligned with the ~~firm's~~SDDT's business strategies.

~~2.9M~~55 For the assumptions identified in ~~2.9J~~52, ~~a firm~~ an SDDT with significant exposure to products with embedded customer optionality should consider and identify the following:

- (i) the potential impact on current and future loan prepayment speeds arising from the interest rate scenario, underlying economic environment, and contractual features;
- (ii) the responsiveness of product rates to changes in market interest rates; and
- (iii) the migration of balances between product types as a result of changes in their features, terms and conditions.

~~2.9N~~56 For the assumptions identified in ~~2.9J~~52, ~~a firm~~ an SDDT with significant exposure to products without specific repricing dates should consider and identify the following:

- (i) the proportion of 'core' balances that are stable and unlikely to reprice even under significant changes in interest rate environment;
- (ii) the depositor characteristics (eg retail/wholesale) and account characteristics (eg transactional/non-transactional);
- (iii) the potential migration between deposits without specific repricing dates and other deposits that could modify, under different interest rate scenarios, key behavioural modelling assumptions;
- (iv) the potential constraints on the repricing of retail deposits in low or negative interest rate environment;

- (v) ensure that assumptions about the decay of core and other modelled balances are prudent and appropriate in balancing the benefits to earnings against the additional economic value risk entailed in locking in a future interest rate return on the assets financed by these balances, and the potential forgone revenue under a rising interest rate environment; and
- (vi) the impact of the assumptions on the ~~firm's~~SDDT's own chosen risk measurement outputs and internal capital allocation decisions, including by periodically calculating sensitivity analyses on key parameters (eg percentage and maturity of core balances on accounts and pass-through rate) and the measures using contractual terms rather than behavioural assumptions to isolate the impact of assumptions on both economic value and earnings.

2.~~9Q57~~A firm An SDDT should have assumptions which are conceptually sound and reasonable, and consistent with historical experience, and establish and apply a robust process for testing the validity of the assumptions. The testing process should include sensitivity analyses to monitor the impact of the assumptions on economic value and earnings-based measures.

2.~~9P58~~ Where ~~a firm~~an SDDT decides to adopt a policy intended to stabilise earnings arising from its own equity, it should:

- (i) have an appropriate methodology for determining what elements of equity capital should be considered eligible for such treatment;
- (ii) determine what would be a prudent investment maturity profile for the eligible equity capital that balances the benefits of income stabilisation arising from taking longer-dated fixed-return positions against the additional economic value sensitivity of those positions under an interest rate stress, and the risk of earnings underperformance should rates rise;
- (iii) include appropriate documentation of these assumptions in its policies and procedures, and include a process for keeping them under review;
- (iv) understand the impact of the chosen maturity profile on the ~~firm's~~SDDT's own chosen risk measurement outputs, including by regular calculation of the measures without inclusion of the equity capital to isolate the effects on both EVE and earnings perspectives; and
- (v) undertake stress testing to understand the sensitivity of risk measures to changes in key assumptions for equity capital, taking the results of such tests into account in its IRRBB internal capital allocation decisions.

~~2.9Q59~~ The data on which ~~a firm's~~an SDDT's measurement systems and models for IRRBB are based should be sufficiently accurate and appropriately documented.

~~2.9R60~~—~~A firm~~ An SDDT should set up appropriate processes to ensure that the data referred to in ~~2.9Q59~~ is consistent with the data used for financial planning.

~~2.9S61~~—~~A firm~~ An SDDT should establish, maintain and apply appropriate governance processes for ensuring the ongoing adequacy of the models. This includes ensuring models are subject to adequate controls and testing, including any data mapping, to provide assurance on the accuracy of their calculations. ~~A firm~~An SDDT should ensure that its internal audit function annually reviews the integrity and effectiveness of the risk management system and the model risk management process.

~~2.9T62~~ Prior to deployment, and on a regular basis, the model should be reviewed and validated independently of model development.

~~2.9U63~~—~~A firm~~ An SDDT should establish exception trigger events that require notification to the management body or its delegates under ~~2.8E36~~ in a timely manner if those events occur.

~~2.9V64~~ When using third-party models, ~~a firm~~an SDDT should:

- (i) document and explain model specification choices as part of the validation process;
- (ii) ensure the models can be adequately customised to properly reflect the specific characteristics of the ~~firm~~SDDT; and
- (iii) determine if inputs to models that are provided by third parties are reasonable for its business and the risk characteristics of its activities.

~~2.10~~—~~[Moved to 2.12A]~~

~~2.40A65~~ The management body or its delegates should receive:

- (i) the outcomes of the ~~firm's~~SDDT's measurement of IRRBB; and
- (ii) reports on the level and trend of the ~~firm's~~SDDT's IRRBB. This should be at least quarterly, and more frequently for firms with greater or more complex risk profiles.

~~2.40B66~~ The reporting referred to in ~~2.40A65~~ (ii) should be broken down by the appropriate levels of consolidation and currency and include at least:

- (i) summaries of the ~~firm's~~SDDT's aggregate exposures to IRRBB, including information on exposures to gap risk, basis risk and option risk;

- (ii) explanation of assets, liabilities, cash flows and strategies that are driving the level and direction of the ~~firm's~~SDDT's IRRBB;
- (iii) reports showing the extent of compliance of current exposures with policies and limits in ~~2.8B, 2.8C;~~2.33, 2.34;
- (iv) the key modelling assumptions, such as characteristics of non-maturity deposits, prepayments on fixed rate loans, early withdrawals of fixed term deposits, drawing of commitments, currency aggregation and treatment of commercial margins;
- (v) the results of stress tests and measurements from the scenarios referred to in ~~2.9D~~2.46, including sensitivity analysis for key model assumptions and parameters;
- (vi) the results of the calculation under ~~Internal Capital Adequacy Assessment~~ICAA 9.4A;
- (vii) comparisons of past forecasts or risk estimates with actual results to inform potential modelling shortcomings on a regular basis; and
- (viii) identification of portfolios that may be subject to significant mark-to-market movements.

~~2.11~~ [Deleted]

~~2.11A~~67 Under ~~Internal Capital Adequacy Assessment~~ICAA 13.1, ~~a firm~~an SDDT is required to make a written record of its assessments made under those rules. ~~A firm's~~An SDDT's record of its approach to evaluating and managing interest rate risk as it affects the ~~firm's~~SDDT's non-trading book activities should cover the following issues as appropriate:

- (i) the internal definition of the boundary between 'banking book' and 'trading activities';
- (ii) the definition of economic value and its consistency with the method used to value assets and liabilities (eg discounted cash flows);
- (iii) the size and the form of the different shocks to be used for internal calculations;
- (iv) the use of a dynamic and/or static approach in the application of interest rate shocks;
- (v) the treatment of commonly called 'pipeline transactions' (including any related hedging);
- (vi) the aggregation of multi-currency interest rate exposures;
- (vii) the inclusion (or not) of non-interest bearing assets and liabilities (including capital and reserves);

- (viii) the treatment of current and savings accounts (ie the maturity attached to exposures without a contractual maturity);
- (ix) the treatment of fixed-rate assets or liabilities where customers still have a right to repay or withdraw early;
- (x) the extent to which sensitivities to small shocks can be scaled up on a linear basis without material loss of accuracy (ie covering both convexity generally and the non-linearity of pay-offs associated with explicit option products);
- (xi) the degree of granularity employed (eg offsets within a time bucket);
- (xii) whether all future cash flows or only principal balances are included;
- (xiii) the results of the calculation under ~~Internal Capital Adequacy Assessment~~ ICA 9.4A;
- (xiv) the use of conditional or unconditional cash flow modelling approaches;
- (xv) the internal definition of commercial margins and adequate methodology for internal treatment of commercial margins;
- (xvi) the definition of earnings risk and its consistency with the method used for developing financial plans and financial forecasts;
- (xvii) the size and tenor of internal limits on IRRBB, and whether these limits are reached at the point of capital calculation;
- (xviii) the effectiveness and expected cost of hedging open positions that are intended to take advantage of internal expectations of the future level of interest rates;
- (xix) the sensitivity of the internal measures of IRRBB to key modelling assumptions;
- (xx) the impact of shock and stress scenarios on positions priced off different interest rate indices (basis risk);
- (xxi) the impact on economic value and earnings of mismatched positions in different currencies;
- (xxii) the impact of embedded losses;
- (xxiii) the distribution of capital relative to risks across legal entities that form part of a capital consolidation group, in addition to the adequacy of overall capital on a consolidated basis;
- (xxiv) the drivers of the underlying risk; and

(xxv) the circumstances under which the risk might crystallise.

~~2.12 [Moved to 2.9C]~~

~~2.12A~~⁶⁸ For building societies, interest rate risk should also be managed with reference to PRA ~~Supervisory Statements~~^{supervisory statement} SS20/15,¹⁷ ‘Supervising building societies’¹, treasury and lending activities’¹⁷. Only societies not on the administered or matched approach to financial risk management should incur any significant interest rate risk.

~~2.12B~~⁶⁹ ~~Firms~~ ~~SDDTs~~ implementing the standardised framework under ~~Internal Capital Adequacy Assessment~~^{ICA} 9.13 should generally consider the most recent 10 years of data when determining the core portion of non-maturing deposits under ~~Internal Capital Adequacy Assessment~~^{ICA} 9.34(1).

Market risk

~~2.13 Firms should provide in their ICAAP document sufficient supplementary evidence, to an auditable standard, which shows how the firm’s capital add-on for market risk is calculated. Specifically, firms need to provide evidence of sound approaches for assigning liquidity horizons in stressed situations, and demonstrate a conservative translation of liquidity horizons into appropriately severe stress scenarios.~~

~~2.14 The PRA expects firms to submit this supplementary internal methodology documentation, when pertinent, on a quarterly basis.~~

~~2.15 To this end, the PRA expects firms to:~~

- ~~□ identify illiquid, one-way or concentrated positions;~~
- ~~□ stress these positions (or risk factors) over an appropriate holding period (ie greater than ten days) and confidence level;~~
- ~~□ identify any capital mitigants already in place that directly relate to the illiquid, one-way or concentrated positions (eg capital for Risks not in VaR (RNIVs), capital for the Incremental Risk Charge (IRC) and reserves (such as bid/ask and prudential valuation reserves)); and~~
- ~~□ suggest a Pillar 2A capital amount based on the stressed losses and capital mitigants or reserves.~~

Group risk

~~2.16 Under the PRA Rulebook a firm is required to have adequate, sound and appropriate risk management processes and internal control mechanisms for the purpose of assessing and managing its own exposure to group risk, including sound administrative and accounting procedures.¹⁸~~

¹⁷ —PRA ~~Supervisory Statements~~^{supervisory statement} 20/15, ‘Supervising building societies’ treasury and lending activities’, January 2021; [‘Supervising building societies’ treasury and lending activities | Bank of England](#)

¹⁸ —Group Risk Systems 2.1.

~~2.16A Group risk, as defined in the PRA Rulebook,¹⁹ means the risk that the financial position of a firm may be adversely affected by its relationships (financial or non-financial) with other entities in the same group or by risk which may affect the financial position of the whole group, including reputational contagion.~~

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

~~2.16AB Specifically, where a financial sector entity's²⁰ contribution to the consolidation group's risk weighted assets (RWAs) exceeds 5%, and its capital ratio (defined as own funds divided by total RWAs) is lower than the consolidation group's total capital requirement, the firm is expected to:~~

- ~~☐ identify in its ICAAP document any mitigating actions it is taking to manage this under-allocation;²¹ or~~
- ~~☐ demonstrate that there is no group risk from the under-allocation of capital to this entity (eg because there is no current or foreseen material, practical, or legal impediment to the prompt transfer of resources to that entity; the shortfall is temporary; or the safety and soundness of the entity is not material to the financial position of the firm or the consolidation group of which it is a member).~~

~~2.16AC Where a firm is a member of a consolidation group, and the group includes an entity established outside the United Kingdom, the PRA expects the firm, when it is assessing group risk, to consider any capital requirements or buffers applied to the entity²² established outside the United Kingdom. Specifically, the PRA expects a firm to consider the extent to which:~~

- ~~☐ for any given risk type, the minimum requirements applied to the entity exceed the entity's share of the consolidated group requirements for the same underlying risk; and~~
- ~~☐ any buffers applied to the entity exceed the entity's share of the consolidated group buffer applied for the same underlying risk.²³~~

~~2.16AD An entity's share of a particular consolidated group capital requirement or buffer can be determined by multiplying that consolidated group capital requirement or buffer by the proportion of the consolidated group's Pillar 1 RWAs that are attributable to that entity. The~~

¹⁹ Internal Capital Adequacy Assessment 1.2

²⁰ As defined in Article 4.1 of CRR.

²¹ Mitigating actions might include, for example, the reallocation of resources from other entities within the group or the raising of additional capital resources.

²² Whether on an individual, sub-consolidated, or country-level consolidated basis.

²³ For example, the extent to which any domestic systemically important bank (D-SIB) buffer exceeds the D-SIB's share of any group-wide global systemically important bank (G-SIB) buffer, after accounting for the effect of risks that net off on consolidation.

~~consolidated group's RWAs that are attributable to an entity is calculated as the entity's Pillar 1 RWAs minus the risk-weighted exposures of the entity to other group entities.~~

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

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

- ~~☐ are already mitigated through the risk-based capital framework (including requirements that are higher than the equivalent requirement applied on a consolidated basis because of a difference of approach between the PRA and the regulatory authority in the jurisdiction concerned)²⁴ or by other means;²⁵ or~~
- ~~☐ net off in consolidation (eg intragroup risks and offsetting positions).~~

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

- ~~☐ for any given risk type, the minimum requirements or buffers applied to an entity established outside the United Kingdom that exceed the entity's share of the consolidated group requirements for the same risk or buffer;~~
- ~~☐ any such differences that the firm considers are already mitigated through the risk-based capital framework or by another means; and~~
- ~~☐ how any additional capital to cover group risk has been calculated.~~

~~2.16AH Under the Senior Managers Regime (SMR),²⁶ firms are required to allocate a Prescribed Responsibility (PR) for managing the allocation and maintenance of the firm's capital, funding and liquidity to an individual performing a Senior Management Function (SMF).²⁷ The PRA expects:~~

- ~~☐ the SMF allocated this PR to ensure that the firm conducts the assessments specified in paragraphs 2.16AA to 2.16AG, and to document them in the firm's ICAAP submissions; and~~
- ~~☐ firms to ensure this expectation is explicitly reflected in the relevant SMF's Statement of Responsibilities.~~

²⁴ For example, a PRA-authorised firm may have permission to use an IRB model to calculate consolidated capital requirements in respect of a portfolio of credit risk exposures. If its overseas subsidiary is required to use a standardised approach for the same portfolio of credit risk exposures (on an individual or sub-consolidated basis), and as a result it is subject to higher requirements in respect of that portfolio, the PRA would not expect the firm to take the difference into account in its assessment of group risk.

²⁵ For example, the risk of a local entity might be mitigated at the group level through risk management processes or internal control mechanisms established at the group level.

²⁶ See Rule 4.1(7) in the Allocation of Responsibilities part of the PRA Rulebook and Supervisory Statement 28/15 'Strengthening individual accountability in banking', May 2017:
<https://www.bankofengland.co.uk/prudential-regulation/publication/2015/strengthening-individual-accountability-in-banking-ss>.

²⁷ Typically the Chief Finance function (SMF2) or, depending on the organisational structure of a group, a Group Entity Senior Manager (SMF7).

Ring-fenced body (RFB) group risk

2.16B RFB group risk means, in relation to a consolidation group containing an RFB sub-group,²⁸⁻²⁹ the risk that the financial position of a firm on a consolidated basis may be adversely affected by the minimum capital and buffers applicable at the level of the RFB sub-group, such that there is insufficient capital within (or an inappropriate distribution of capital across) the consolidated group to cover the risks of the consolidated group.

2.16C The PRA therefore expects a firm that is a member of a consolidation group containing an RFB sub-group to ensure that the minimum capital and buffers applicable at the level of the RFB sub-group do not result in the consolidated group having insufficient capital within it, or an inappropriate distribution of capital across it, to cover the risks faced by the consolidation group; and in order to ensure that RFB group risk is adequately covered in consolidated group capital, firms are expected to take account of this risk when carrying out an ICAAP on a consolidated basis.

2.16D When a firm is assessing RFB group risk as part of its ICAAP on a consolidated basis, the PRA expects it to consider, to the extent not already covered by other elements of the capital framework, the following:

- the extent to which any other systemically important institutions buffer (O-SII buffer) exceeds the RFB sub-group's share³⁰ of any group-wide global systemically important bank (G-SIB) buffer;
- the extent to which the amount of capital applicable at the level of the RFB sub-group to cover the credit concentration risk on a sub-consolidated basis exceeds the RFB sub-group's share³¹ of the capital applicable at the level of the consolidated group to cover the credit concentration risk on a consolidated basis;
- any minimum capital and buffers applicable at the level of the RFB sub-group attributable to risk-weighted exposures of the RFB sub-group to group entities that are not members of the RFB sub-group (to the extent RFB group risk in relation to those exposures is not already captured by the assessment of other aspects of RFB group risk covered in this paragraph); and
- as appropriate, the amount by which the minimum capital or buffers applicable at the RFB sub-group level to cover any other risk exceed the RFB sub-group's minimum capital or buffers applicable at the consolidated group level to cover the same risk. (This could include, for example, interest rate risk in the banking book, operational risk or the risk of the consolidated group being undercapitalised following the application of PRA rules on deduction of significant investments in financial sector entities at the level of the RFB sub-group.)³²

²⁸ An RFB sub-group is a sub-set of related group entities within a consolidation group, consisting of one or more RFBs and other legal entities, which is established when the PRA gives effect to Article 11(5) of the CRR. See SS8/16 'Ring-fenced bodies (RFBs)', February 2017: <https://www.bankofengland.co.uk/prudential-regulation/publication/2016/ring-fenced-bodies-ss> for more detail.

²⁹ In the event that an RFB is not part of an RFB sub-group, the PRA expects to apply an equivalent approach in the event that prudential requirements are applicable to the RFB on an individual basis.

³⁰ This share can be determined by multiplying the global systemically important bank (G-SIB) buffer by the proportion of the consolidated group's Pillar 1 RWAs (ie the total risk exposure amount calculated in accordance with Article 92(3) of the CRR) that are attributable to the RFB sub-group.

³¹ This share can be determined by multiplying the capital applicable at the level of the consolidated group to cover the credit concentration risk on a consolidated basis by the proportion of the consolidated group's credit risk RWAs that are attributable to the RFB sub-group.

³² See paragraphs 2.1 and 2.2 in the Definition of Capital Part of the PRA's Rulebook.

~~2.16E Pension obligation risk: As set out in SS8/16, the PRA expects an RFB to ensure it has fully and appropriately considered group risk arising in respect of its pension arrangements when conducting its assessment of pension obligation risks at the level of the RFB sub-group. The PRA expects an RFB to consider all relevant factors when performing its assessment, including, but not limited to, its current share of consolidated group pension obligations, and its expected future share where it is making changes to its pension arrangements. An RFB's assessment should not be limited to a simple allocation of a share of the consolidated group's pension obligation risk. A full assessment may therefore result in a higher capital requirement than if the RFB were to apply a 'share-of-group' approach, particularly in the period prior to 1 January 2026. The PRA also expects to apply its existing policy, as set out in this supervisory statement, when assessing the pension obligation risk of a consolidated group containing an RFB. The PRA expects the assessment of RFB group risk at group level to be unaffected by the assessment of the pension obligation risk for the RFB sub-group given:~~

- ~~□ the transitional nature of the risk; and~~
- ~~□ assuming the sum of the amount of pension risks at the level of the RFB sub-group and group entities that are not members of the RFB sub-group is not expected to increase to a level above that of the consolidated group in the event that the RFB will have to assume the pension liabilities of group entities that are not members of the RFB sub-group.~~

~~2.16F This exception only applies to the assessment of pension risk and should not be taken to mean that other risks with proportionately higher requirements should not be included in the assessment of RFB group risk.~~

~~2.16G In respect of the obligation under Internal Capital Adequacy Assessment 13.1, the PRA expects that firms should provide in their ICAAP document sufficient supplementary evidence, to an auditable standard, to demonstrate clearly how the additional capital to cover RFB group risk is calculated. Specifically, firms should provide a breakdown of the total amount of the additional capital, identifying the amount of capital attributable to each part of the assessment referred to in paragraph 2.16D.~~

Operational risk

~~2.17 In meeting the general standard referred to in Internal Capital Adequacy Assessment 10.1, a firm that undertakes market-related activities should be able to demonstrate to the PRA:~~

- ~~□ in the case of a firm calculating its capital requirements for operational risk using the Basic Indicator Approach or Standardised Approach, that it has considered; or~~
- ~~□ in the case of a firm with an Advanced Measurement Approach (AMA) permission, that it has complied with, the Committee of European Banking Supervisor's Guidelines on the management of operational risk in market-related activities published in October 2010.³³~~

~~2.18 In meeting the general standard referred to in Internal Capital Adequacy Assessment 10.1, a firm with an AMA approval should be able to demonstrate to the appropriate regulator~~

³³ ~~<https://www.eba.europa.eu/regulation-and-policy/operational-risk/guidelines-on-the-management-of-operational-risk-in-market-related-activities>.~~

~~that it has considered and complies with Section III of the EBA's Guidelines on the AMA — Extensions and Changes, published in January 2012.³⁴~~

~~2.19 Business continuity plans are also a key component of operational risk management. Plans should include consideration of:~~

- ~~□ resource requirements such as people, systems and other assets, and arrangements for obtaining these resources;~~
- ~~□ the recovery priorities of the firm's operations;~~
- ~~□ communication arrangements for internal and external concerned parties (including the PRA, clients and the media);~~
- ~~□ escalation and invocation plans that outline the processes for implementing the business continuity plans, together with relevant contact information;~~
- ~~□ processes to validate the integrity of information affected by the disruption; and~~
- ~~□ regular stress testing of the business continuity plan in an appropriate and proportionate manner.~~

~~2.20 In addition, the PRA does not expect that smaller firms will complete the operational risk data items but expects such firms to provide in their ICAAP document at least the following information (historical losses at an aggregate level are regularly available to the PRA via COREP 17):~~

- ~~(i) forecast operational risk losses, broken down between conduct and non-conduct losses and by future year; and~~
- ~~(ii) information on the operational risk scenarios they have considered in their ICAAP, covering a description of such scenarios and an assessment of their impact and likelihood.~~

Pension obligation risk

³⁴ ~~<https://www.eba.europa.eu/-/guidelines-on-ama-extensions-and-chang-1->~~

2.21 Pension obligation risk

2.70 The PRA's framework for Pillar 2A pension obligation risk capital consists of two elements:

- the **firm'sSDDT's** own assessment of the appropriate level of Pillar 2A pension obligation risk capital; and
- a set of stresses on the accounting basis which will be used by the PRA in assessing the adequacy of the **firm'sSDDT's** own assessment of the level of capital required.

2.22-71 The **firm'sSDDT's** own assessment and the stress tests on the accounting basis can be reduced by:

- offsets and management actions; and
- any pension scheme deficit deducted from Common Equity Tier 1 (CET1).

2.23-72 The PRA expects **firmsSDDTs** to carry out their own assessment of the appropriate level of Pillar 2A pension obligation risk capital in their ICAAP. Firms should use methodologies and assumptions that are consistent with their approach to risk management and are therefore not restricted to using the IAS 19 basis in carrying out this assessment.

2.24-73 In carrying out their assessment, **firmsSDDTs** should consider risks to the financial position of their pension schemes consistent with a stress event that has no more than a 1 in 200 probability of occurring in a one-year period.

2.25-74 For the purpose of **firms'SDDTs'** own assessment of Pillar 2A pension obligation risk capital, the PRA expects **firmsSDDTs** to use stress testing and scenario analysis where appropriate to quantify the gross impact on the existing scheme surplus or deficit. The PRA does not necessarily favour a stochastic approach over a deterministic one. Firms should decide which approach is most appropriate.

2.26-75 As part of their ICAAP submission, **firmsSDDTs** are required to calculate and (if they have a defined benefit pension scheme) report the stressed accounting value of their pension scheme's assets and liabilities using stress scenarios specified by the PRA in accordance with **PRA Statement of Policy, the draft SoP 'The PRA's methodologies for setting Pillar 2 capital'** **capital for Small Domestic Deposit Takers (SDDTs)** and Reporting Pillar 2, 2.6 as set out in the PRA Rulebook. This requirement is in addition to the **firm'sSDDT's** own assessment referred to above, unless the data required in that data item have already been reported to the PRA by other means. In doing so **firmsSDDTs** are expected to:

- calculate the stressed value of assets and liabilities assuming all the elements of the stress apply instantaneously and simultaneously;

- decompose the IAS 19 discount rate into a risk-free element and a credit spread element. Firms should make use of their own methodology to do so but should provide a description of the approach taken in their ICAAP. The long-term interest rate stress should be applied to the risk-free element and the credit stress to the credit spread element in order to derive the stressed discount rate; and
- use their own methodology to decompose the yield on bonds into a risk-free element and a credit spread element and describe the approach taken in their ICAAP.

2.27-76 The PRA expects the valuation measure of liabilities to be the same as that used for International Financial Reporting Standards (IFRS) reporting. The PRA expects firms' SDDTs approaches to setting the valuation assumptions to be stable over time and any changes to the approach should be justified in the ICAAP document.

2.28-77 More information on the scenarios is available in PRA Statement of Policy, the draft SoP 'The PRA's methodologies for setting Pillar 2 capital for Small Domestic Deposit Takers (SDDTs).' The PRA scenarios are highly simplified by design and firms SDDTs should decide which stresses to apply to individual asset and liability classes. The broadest possible interpretation should be used (eg a single stress is specified for equity prices); and this should be applied to all categories of investments that exhibit properties similar to listed equities, such as UK equities, overseas equities, unlisted equities, private equity and limited partnerships.

2.29-78 Where firms SDDTs believe that the scenarios produce inappropriate levels of capital for their pension schemes, they should provide evidence of this together with a detailed explanation in their ICAAP document.

2.30-79 When considering management actions and offsets, firms SDDTs must clearly demonstrate that offsets are valid and that management actions are realistic. They must also demonstrate that both offsets and management actions do not result in double counting and would be effective under stressed conditions.

Pension obligation risk in firms SDDTs and groups

2.31-80 Firms should ordinarily hold pension obligation risk capital against the total liability resulting from past or present employment:

- with the firm SDDT (including any legacy or overseas entities); and
- outside the firm SDDT, pro-rated according to whether the pension fund principal beneficiaries' service was performed for the benefit of the firm SDDT.

2.32-81 Firms should also consider whether they may be exposed to pension obligation risk greater than that captured by these general criteria, given the potential for The Pensions

Regulator to impose a contribution notice or a financial support direction on any company associated with an employer.

2.33-82 When Pillar 2A pension obligation risk capital is calculated at group level, these expectations apply to the group as a whole. Accordingly, firmsSDDTs must allocate Pillar 2A pension obligation risk capital to entities within the group in a way that adequately reflects the nature, level and distribution of the risks to which the group is subject.

Pension obligation risk: addressing the risk of increased pension losses near the point of resolution

2.34-83 There are situations where liabilities related to a defined benefit pension fund may, as the sponsor firm's financial condition deteriorates, increase substantially and unexpectedly above the stressed deficit which is covered under Pillar 2A.³⁵

2.35-84 Should such events materialise as a firm's an SDDT's financial condition deteriorates, unexpected losses well in excess of Pillar 2A capital already set aside might crystallise prior to the point of resolution.

2.36-85 In order to address the risk of increased pension losses near the point of resolution, the PRA expects firmsSDDTs to articulate in their ICAAP document how they intend to deal with the defined benefit pension scheme under relevant firm-specific extreme scenarios, bearing in mind the potential for additional loss and describing available management actions. The analysis should be sufficient to demonstrate the institution's awareness around this tail risk and the adequacy of its mitigating actions. The actions should be consistent with the firms'SDDTs' recovery and resolution plans. Additionally, under Reporting Pillar 2 2.6 firmsSDDTs with defined benefit pension schemes must calculate and report to the PRA their defined benefit pension scheme deficit if a debt became due under section 75 of the Pensions Act 1995, unless the data required in that data item have already been reported to the PRA by other means.

³⁵ –The following events could trigger such losses: a request to the firm, by the pension trustee, to make additional payments to the pension fund when there is a concern that the firm may not be able to continue to make payments in the future (eg due to its deteriorating financial conditions); a different valuation of the firm's assets and liabilities under duress (eg under Article 36 of the Bank Recovery and Resolution Directive when recovery actions are initiated and/or prior to conversion/write-off of capital instruments); a loss on transfer of the scheme to another party (eg if required as part of a recovery action); and a trigger of an insolvency event.

Counterparty credit risk

2.86 Counterparty credit risk (CCR) is not captured under Pillar 1 capital requirements for SDDTs for derivatives (except in some specific cases³⁶). However, the PRA expects SDDTs to have appropriate governance, risk management and internal control mechanisms for the purpose of measuring and mitigating CCR.

2.87 When an SDDT is assessing their risks to counterparty credit risk as part of meeting the general standards referred to in Internal Capital Adequacy Assessment 4, it should consider the following:

Governance of CCR

2.88 SDDTs are expected to have robust risk management and governance procedures in place that include:

- (i) a risk management framework that considers the identification, measurement, active management, approval, and internal reporting of CCR;
- (ii) active involvement from senior management in overseeing the risk management processes, and allocating sufficient resources as required;
- (iii) a documented set of internal policies, standard operating procedures and internal risk controls.

Risk Measurement and Risk Management of CCR

2.89 SDDTs should have in place appropriate arrangements to measure and manage the risks to the SDDT from counterparty credit risk. These arrangements should include:

- (i) a process to measure exposures and/or risks to counterparties;
- (ii) consideration of how such exposures and/or risks may change during periods of stress;
- (iii) consideration of the credit quality of counterparties, including processes to monitor credit quality and set counterparty limits where appropriate;
- (iv) use of collateralisation to minimise exposure, either via bilateral arrangements or use of central clearing; and

³⁶ Trade exposures and default fund contributions if an SDDT is a clearing member of a CCP, and securitisation positions that result from derivative instruments.

- (v) comprehensive documentation of contractual terms and conditions with their counterparties.

Reviews

2.90 An SDDT should review and evaluate the effectiveness of its framework on a regular basis, and at least annually.

Exposures to securitisation

2.91 When an SDDT assesses risks associated with exposures to securitisation as part of its ICAAP, it should consider the following:

- (i) the risk characteristics and structural features of a securitisation, including those of the underlying exposures, which could materially impact the performance of any positions in that securitisation held by the SDDT;
- (ii) whether the application of another method, namely SEC-IRBA, SEC-ERBA or SEC-SA, insofar as that method may be used, would result in material differences in risk weights for a position relative to the method applied; and
- (iii) the extent to which differences in risk-weights identified in (ii) may be caused by the risk characteristics and structural features identified in (i) as well as the approach taken by an External Credit Assessment Institution (ECAI) in rating a particular asset class.

2.92 An SDDT's record under ICAA 13.1 of its approach to evaluating and managing securitisation risk (or credit risk arising from securitisation exposures) should cover the following, as appropriate, taking into account SS9/13 'Securitisations: Significant Risk Transfer':

- (i) the appropriateness of the credit risk weight calculated for the asset classes to which the SDDT is exposed via securitisation;
- (ii) risk characteristics and structural features exhibited by securitisations to which the SDDT is exposed, that may materially impact the performance of the securitisation position, and are not explicitly taken into account by the method applied;
- (iii) a breakdown of the SDDT's aggregate securitisation exposure, split by asset class, risk characteristic or other feature as appropriate, with the following information:
 - a. for the aggregate exposure risk-weighted under the SEC-IRBA, risk-weighted exposure amounts split by asset class, risk characteristic or other feature as appropriate, which would be arrived at under the SEC-IRBA, SEC-ERBA (for rated positions only) and the SEC-SA insofar as each method may be used; and

b. for the aggregate exposure which is both risk-weighted under the SEC-SA and rated, risk-weighted exposure amounts which would be arrived at under the SEC-ERBA insofar as that method may be used.

(iv) The SDDTs' aggregate exposure and aggregate risk-weighted exposure amounts to unrated securitisation positions.

Financial risks from climate change

2.93 The PRA expects SDDTs to understand the financial risks from climate change and how these will affect their business model. SDDTs should use scenario analysis and stress testing to inform the risk identification process and to understand the short- and long-term financial risks to their business model from climate change.

2.94 SDDTs should refer to **SS3/19 - 'Enhancing banks' and insurers' approaches to managing the financial risks from climate change'**³⁷ for the PRA's expectations for ICAAPs in relation to financial risks from climate change.

Market risk

2.95 Market risk is the risk of losses resulting from adverse changes in the value of positions arising from movements in market prices across commodity, credit, equity, FX and interest rates risk factors.

2.96 The PRA considers that market risk is generally not relevant for SDDTs. However, the PRA expects SDDTs to adequately capitalise against risks they are exposed to. If an SDDT is exposed to market risk, it will be subject to the relevant expectations set out in SS31/15.

³⁷ April 2019 – **SS3/19 - Enhancing banks' and insurers' approaches to managing the financial risks from climate change** | Bank of England

Group risk

2.97 Group risk, as defined in the PRA Rulebook,³⁸ means the risk that the financial position of a firm may be adversely affected by its relationships (financial or non-financial) with other entities in the same group or by risk which may affect the financial position of the whole group, including reputational contagion.

2.98 The PRA considers that group risk is generally not relevant for SDDTs. However, the PRA expects SDDTs to adequately capitalise against risks they are exposed to. If an SDDT is exposed to group risk, it will be subject to the relevant expectations set out in SS31/15.

Foreign currency lending to unhedged retail and SME borrowers

2.3799 Foreign currency lending is defined in the EBA Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP).³⁹ 2.38 As part of its obligation under Internal Capital Adequacy Assessment 3.1 a firm The PRA considers that lends in risks arising from foreign currency lending to unhedged retail and SME borrowers should determine whether it meets the thresholds of materiality in Title 6, Section 1 paragraph 117 of the EBA's Guidelines on common procedures and methodologies for the SREP. Where a firm meets the threshold it should notify the PRA and reflect the risk in its ICAAP.

Exposures to securitisation

2.39 When a firm assesses risks associated with exposures to securitisation as part of its ICAAP, it should consider the following:

- (i) the risk characteristics and structural features of a securitisation, including those of the underlying exposures, which could materially impact the performance of any positions in that securitisation held by the firm;
- (ii) whether the application of another method, namely SEC-IRBA, SEC-ERBA or SEC-SA, insofar as that method may be used, would result in material differences in risk weights for a position relative to the method applied; and
- (iii) the extent to which differences in risk weights identified in (ii) may be caused by the risk characteristics and structural features identified in (i) as well as the approach taken by an External Credit Assessment Institution (ECAI) in rating a particular asset class.

2.40 A firm's record under Internal Capital Adequacy Assessment 13.1 of its approach to evaluating and managing securitisation risk (or credit risk arising from securitisation exposures) should cover the following, as appropriate, taking into account SS9/13 'Securitisations: Significant Risk Transfer':

³⁹ [https://www.eba.europa.eu/documents/10180/935249/EBA-GL-2014-13+\(Guidelines+on+SREP+methodologies+and+processes\).pdf](https://www.eba.europa.eu/documents/10180/935249/EBA-GL-2014-13+(Guidelines+on+SREP+methodologies+and+processes).pdf). Title 1 'Subject matter, definitions and level of application' of the EBA Guidelines, Section 2, pages 16 and 18, provide definitions of 'FX lending' and 'unhedged borrowers'.

- ~~(i) the appropriateness of the credit risk weight calculated for the asset classes to which the firm is exposed via securitisation;~~
- ~~(ii) risk characteristics and structural features exhibited by securitisations to which the firm is exposed, that may materially impact the performance of the securitisation position, and are generally not explicitly taken into account by the method applied;~~
- ~~(iii) a breakdown of the firm's aggregate securitisation exposure, split by asset class, risk characteristic or other feature as appropriate, with the following information:

 - ~~(a) for the aggregate exposure risk-weighted under the SEC-IRBA, risk-weighted exposure amounts split by asset class, risk characteristic or other feature as appropriate, which would be arrived at under the SEC-IRBA, SEC-ERBA (for rated positions only) and the SEC-SA insofar as each method may be used; and~~
 - ~~(b) for the aggregate exposure which is both risk-weighted under the SEC-SA and rated, risk-weighted exposure amounts which would be arrived at under the SEC-ERBA insofar as that method may be used.~~~~
- ~~(iv) The firms' aggregate exposure and aggregate risk-weighted exposure amounts to unrated securitisation positions.~~

Financial risks from climate change

~~2.41 The relevant for SDDTs. However, the PRA expects firms SDDTs to understand the financialadequately capitalise against risks from climate change and how they are exposed to. If an SDDT is exposed to foreign currency lending to unhedged retail and SME borrowers, it will affect their business model. Firms should use scenario analysis and stress testing to inform the risk identification process and to understand the short- and long-term financial risks to their business model from climate change.~~

~~2.42 Refer to SS3/19, 'Enhancing banks' and insurers' approaches to managing the financial risks from climate change'⁴⁰ for the PRA'sbe subject to the relevant expectations for ICAAPs in relation to financial risks from climate changeset out in SS31/15.~~

Risk of excessive leverage

~~2.43 The PRA expects firms to carry out an assessment of the risk of excessive leverage. This~~2.100 Excessive leverage risk is defined as the risk resulting from a firm's vulnerability to leverage or contingent leverage that may require unintended corrective measures to its business plan, including distressed selling of assets which might result in losses or in valuation adjustments to its remaining assets.

~~2.44 In carrying out their assessment, firms should consider any contingent leverage risk in transactions and trade structures that receive lower leverage ratio exposure measure values than other economically similar transactions. Contingent leverage risk arises when a firm can~~

⁴⁰ <https://www.bankofengland.co.uk/prudential-regulation/publication/2019/enhancing-banks-and-insurers-approaches-to-managing-the-financial-risks-from-climate-change-ss->

no longer rely on these capital-efficient trades, for example in a stress. The PRA considers that trade structures that may be a source of contingent leverage risk include:

- agency repurchase agreements (repos)⁴¹ and other agency models to transact in security financing transactions (SFTs) or derivatives, SFT and repo netting packages, collateral swaps, and unsecured borrowing or lending of securities; and
- internalised positions⁴² (including written credit derivatives and prime brokerage business).

2.45 Further, firms should also consider any additional trade structures that have a lower leverage ratio exposure value than economically similar trades that firms judge may give rise to material contingent leverage risk.

2.46 The extent to which firms can use these more capital-efficient forms of trades may be limited in certain conditions, such as in the event of the default of counterparties, the movement of certain market parameters, or changes to broader market conditions. For example:

- Netting: client withdrawal from one leg of a transaction that is netted, or one-directional markets in stress, could lead to a lack of availability of netting opportunities for firms' financing activities. This may result in loss of netting and an increase in firms' total exposure measure for the purposes of the leverage ratio.
- Internalisation: a client may withdraw or default from one leg of a synthetic prime brokerage transaction that is internally offset for hedging purposes. If the firm cannot replace the offsetting synthetic leg, the firm may use a cash hedge for the remaining leg of the transaction, increasing its total leverage exposure. In the case of written credit derivatives (in line with 'Article 429d' of the Leverage Ratio (CRR) Part of the PRA Rulebook), the loss of an offsetting leg may result in the loss of conditions that allow the firm to internalise the effective notional amount of the credit derivative, and increase a firm's total exposure.
- Collateral swaps: some lower-quality forms of collateral may become less available in certain market conditions, and firms may have to replace the affected collateral swaps with other forms of financing.

⁴¹—Agency repos are transactions where a firm acts as an agent between two parties in a repurchase agreement or a reverse repurchase agreement involving the exchange of cash, in line with Article 429e(7) of Chapter 3 of the Leverage Ratio (CRR) Part of the PRA Rulebook

⁴²—Internalisation is whereby, if a firm has two clients that are taking opposite positions on the same asset (one long, the other short), the firm may internally offset these amounts to avoid having to fund the positions elsewhere: a client short position is therefore funding a client long position. This definition is consistent with the one provided in the PRA's Statement of Policy 'Pillar 2 Liquidity'

2.47 Firms should consider the extent to which they would need, and be able, to continue to participate in these trades and the extent to which they would instead need to use economically similar transactions or structures that receive higher leverage ratio exposure measure values. Firms should consider the impact this might have on their leverage ratio and other regulatory measures (such as liquidity or risk-weighted metrics) as relevant.

2.48 Firms may have to continue exposure⁴³ to transactions or trade structures that receive higher leverage ratio exposure measure values for a variety of reasons, including contractual obligations, franchise considerations, liquidity management, or other commercial reasons. To the extent that firms would not continue to participate in such trades in certain circumstances, firms should consider what implications this might have for their revenues. Examples of risks and assumptions that firms should pay particular consideration to include, but are not limited to:

- Contractual obligations: firms may be contractually obliged to maintain transactions with certain counterparties, even in circumstances where doing so might be detrimental to the firm's leverage ratio position.
- Franchise risk: firms, especially prime brokers, often offer their services to maintain a franchise value with their clients in addition to the revenues generated directly by the business activity. As such, a firm may roll over funding transactions at a client's request even in circumstances where doing so might be detrimental to the firm's leverage ratio position.⁴⁴
- Liquidity management: firms should consider the extent to which they may be able to maintain their funding without having to replace their transactions or trade structures with others that receive higher leverage ratio exposure measure values, such as secured borrowing.

2.49 As part of their ICAAP responses, firms should set out their assessment of contingent leverage risks by each individual trade structure identified in paragraph 2.44 and 2.45 that firms judge may be a material source of contingent leverage risk.

2.50 Factors which firms should consider in assessing the materiality of contingent leverage risk for each trade structure identified in paragraph 2.44 and 2.45 include, for example:

⁴³—Intra-group exposures to other entities within the wider group are in scope of this part of the ICAAP, to the extent that these entities do not fall within the basis (whether solo, sub-consolidated, or consolidated) on which the firm is calculating its leverage ratio.

⁴⁴—This definition of franchise risk is consistent with the one provided in the PRA's Statement of Policy 'Pillar 2 Liquidity'. Firms should apply the two definitions consistently across their assessments of contingent leverage risks under the ICAAP and of liquidity risks under the ILAAP.

- ~~• the extent to which the firm engages in the relevant trade, especially where the trades are subject to contractual obligations, franchise risk, or liquidity management considerations as set out in paragraph 2.48; and~~
- ~~• the size of the impact on the firm's leverage ratio should the firm lose the capital optimisation benefits from the trade and have to replace it with trades that receive higher leverage ratio exposure measure values.~~2.101 The PRA considers that the risk of excessive leverage is generally not relevant for SDDTs. However, the PRA expects SDDTs to adequately capitalise against risks they are exposed to. If an SDDT is exposed to the risk of excessive leverage, it will be subject to the relevant expectations set out in SS31/15.

Draft for consultation

3- Stress testing, scenario analysis and capital planning

3.1- Both stress testing and scenario analysis are forward-looking analytical techniques, which seek to anticipate possible losses that might occur if an identified economic downturn occurs, or a risk event crystallises.

3.2- Stress testing typically refers to shifting the values of individual parameters that affect the financial position of a firm and determining the effect on the firm's financial position.

3.3- Scenario analysis typically refers to a wider range of parameters being varied at the same time. Scenario analyses often examine the impact of adverse events on the firm's financial position, for example, simultaneous movements in a number of risk drivers affecting all of a firm's business operations, such as business volumes and investment values.

3.4- There are three broad purposes of stress testing and scenario analysis:

- (i) as a means of quantifying how much capital might be absorbed if an adverse event(s) occurs;
- (ii) to provide a check on the outputs and accuracy of risk models, particularly in identifying non-linear effects when aggregating risks; and
- (iii) to explore the sensitivities in longer-term business plans and how capital needs might change over time.

3.5 The general stress test and scenario analysis rule in Internal Capital Adequacy Assessment ICA 12.1 requires a firm SDDT to carry out stress tests and scenario analyses as part of its obligations under the overall Pillar 2 rule in Internal Capital Adequacy Assessment ICA 3.1. Both stress tests and scenario analyses are undertaken by a firm SDDT to improve its understanding of the vulnerabilities that it faces under adverse conditions. They are based on the analysis of the impact of a range of events of varying nature, severity, and duration. These events can be economic, financial, operational, or legal, or relate to any other risk that might have an impact on the firm SDDT. Under Recovery and Resolution 2.4 in the PRA Rulebook, a recovery plan must contain a comprehensive range of options setting out actions that could be taken in a number of different scenarios and stresses.

Overall approach

3.6- As part of its obligation under the general stress and scenario testing rule in Internal Capital Adequacy Assessment ICA 12.1, a firm SDDT should undertake a broad range of

stress tests which reflect a variety of perspectives, including sensitivity analysis, scenario analysis and stress testing on individual portfolios as well as at a firm-wide level.

3.7 ~~A firm~~An SDDT should use the results of its stress testing and scenario analysis not only to assess capital needs, but also to decide if measures should be put in place to minimise the adverse effect on the ~~firm~~SDDT if the risks covered by the stress test or scenario analysis actually materialise. Such measures might be a contingency plan or more concrete risk mitigation steps.

3.8- Stress tests and scenario analyses should be carried out at least annually. ~~A firm~~An SDDT should, however, consider whether the nature of the major sources of risks identified by it in accordance with the overall Pillar 2 rule in ~~Internal Capital Adequacy Assessment~~ICA 3.1 and their possible impact on its financial resources suggest that such tests and analyses should be carried out more frequently. For instance, a sudden change in the economic outlook may prompt ~~a firm~~the SDDT to revise the parameters of some of its stress tests and change its scenario analyses. Similarly, if ~~a firm~~an SDDT has recently become exposed to a particular sectoral concentration, it may wish to amend and/or add some stress tests and scenario analyses in order to reflect that concentration.

3.9 -The PRA expects ~~a firm~~an SDDT to project its capital resources and capital requirements over a three-~~to~~-five-year horizon, taking account of its business plan and the impact of relevant adverse scenarios. In making ~~the~~its capital estimate, the ~~firm~~SDDT should consider both the capital resources required to meet its capital requirements under the ~~CRR~~PRA Rulebook and the capital resources needed to meet the overall financial adequacy rule. The ~~firm~~SDDT should make these projections in a manner consistent with its risk management processes and systems.

3.10 -The ~~firm~~SDDT should document its stress testing and scenario analysis policies and procedures, as well as the results of its tests in accordance with ~~Internal Capital Adequacy Assessment~~ICA 13.1. These results should be included within the ~~firm's~~SDDT's ICAAP document.

Governance

3.11 -The PRA expects ~~a firm's~~an SDDT's management body to be actively involved and engaged in all relevant stages of the ~~firm's~~SDDT's stress testing and scenario analysis programme. This would include establishing an appropriate stress testing programme, reviewing the programme's implementation (including the design of scenarios) and challenging, approving and taking action based on the results of the stress tests.

3.12 -The PRA expects ~~firms~~SDDTs to assign adequate resources, including IT systems, to stress testing and scenario analysis, taking into account the stress testing techniques employed, so as to be able to accommodate different and changing stress tests at an appropriate level of granularity.

Scenarios

3.13 ~~Firms~~SDDTs should develop a range of firm-wide scenarios including some based on macroeconomic and financial market shocks for the purposes of their own stress testing. These scenarios should be developed so as to be relevant to the circumstances of ~~the firm~~each SDDT, including its business model, and the market(s) in which it operates.

3.14- In identifying an appropriate range of adverse circumstances and events in accordance with ~~Internal Capital Adequacy Assessment~~ICAA 12.1, ~~a firm~~a SDDT will need to consider:

- (i) the nature, scale and complexity of its business and of the risks that it bears;
- (ii) its risk appetite, including in light of the adverse conditions through which it expects to remain a going concern;

~~□ the cycles it is most exposed to and whether these are general economic cycles or specific to particular markets, sectors or industries;~~

- (iii) the behaviour of counterparties, and of the ~~firm~~SDDT itself, including the exercise of choices (for example, options embedded in financial instruments or contracts of insurance); and

(iv) for the purposes of ~~Internal Capital Adequacy Assessment~~ICAA 12.1, the amplitude and duration of the relevant cycle which should include a severe downturn scenario based on forward-looking hypothetical events, calibrated against the most adverse movements in individual risk drivers experienced over a long historical period.

3.15- The calibration of stress testing and scenario analyses should be reconciled to a clear statement setting out the premises upon which the ~~firm's~~SDDT's internal capital assessment under the overall Pillar 2 rule in ~~Internal Capital Adequacy Assessment~~ICAA 3.1 is based.

Common stress scenarios

3.16 ~~As part of its Annual Stress Testing framework, the Bank of England publishes a common stress scenario aimed at assessing the UK banking system's capital adequacy. This scenario is run concurrently across a number of participating firms, on an annual basis. 3.17 Additionally, for firms not participating in the concurrent~~The PRA publishes annually two non-cyclical stress testing, the PRA publishes a macroeconomic scenario scenarios to serve as a guide and, where relevant, as a severity benchmark, for ~~firms~~SDDTs designing their own stress scenarios.

3.17 These stress testing scenarios are non-cyclical, with a relatively constant impact, meaning that an SDDT's single capital buffer (SCB) (see para 5.16) is relatively insensitive to the C-SREP timing and to the point in the economic cycle when SCB setting occurs. The scenarios are set in such a way that as the economy moves through the economic and financial cycles, the generated stress impact remains, on average, at a relatively constant level (if the SDDT's risk profile and balance sheet remain broadly unchanged). But the stress

impact and thereby the SCB, will vary by SDDT, in accordance with their risk profile and balance sheet. It may also, on rare occasions, change in response to material changes in the structure (i.e., not related to the economic or financial cycle) of the economy or financial system that are relevant for SDDTs.

3.18 ~~Firms~~SDDTs should continue to develop their own scenarios and consider the relevance of the PRA's stress ~~scenarios~~scenarios in the context of their business and specific risk drivers, and use ~~this scenario~~these scenarios as a starting point severity benchmark to build and calibrate their own scenarios. ~~The scenario reflects minimum adverse conditions.~~The severity of the scenarios through which ~~firms should~~SDDTs assess their ability to maintain minimum specified capital levels. ~~should be at least as severe as the PRA's scenarios.~~This is particularly important for specialised firms, or firms whose business models are less affected by the PRA scenario (eg firms with major exposures to countries other than the United Kingdom, mono-lines, and investment banks). 3.19 ~~More generally, all firms should continue to develop their own scenarios and ensure that these are in relation to their business model as the concurrent stress testing scenario (for firms participating in concurrent stress testing) or the scenario published by the PRA (for all other firms).~~ 3.20 ~~The PRA may ask some firms to run concurrent stress test scenarios or the PRA scenario part of their range of stress scenarios for Pillar 2 capital planning. Asking firms to run common scenarios, or scenarios that are broadly comparable in terms of severity (eg for firms with different business models) will allow supervisors to more easily compare and benchmark individual results and firms' approaches to stress testing.~~

3.21 ~~19~~ In identifying adverse circumstances and events in accordance with ~~Internal Capital Adequacy Assessment~~ICAA 12.1, ~~a firm~~a SDDT should consider the results of any reverse stress testing conducted in accordance with ~~Chapter~~ICAA 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~~SDDT's vulnerabilities for the purpose of meeting the ~~firm's~~SDDT's obligations under ~~Internal Capital Adequacy Assessment~~ICAA 12.1. In addition, such a comparison may help ~~a firm~~a SDDT to assess the sensitivity of its financial position to different stress calibrations.

Forward-looking, multi-year risk assessment

3.22 ~~20~~ In carrying out the stress tests and scenario analyses required by the general stress and scenario testing rule in ~~Internal Capital Adequacy Assessment~~ICAA 12.1, the PRA expects ~~a firm~~a SDDT to consider any impact of the adverse circumstances on its capital resources. In determining whether it would have adequate financial resources in the event of each identified severe adverse scenario, the ~~firm~~SDDT should:

- (i) only include financial resources that could reasonably be relied upon as being available in the circumstances of the identified scenario; and
- (ii) take account of any legal or other restriction on the use of financial resources.

3.23 ~~21~~ In making the estimate required by ~~Internal Capital Adequacy Assessment~~ICAA 12.3, ~~a firm~~a SDDT should project both its capital resources and its required capital resources

over a time horizon of three to five years, taking account of its business plan and the impact of relevant adverse scenarios. The ~~firm~~SDDT should consider both the capital resources required to meet its ~~capital requirements under the CRRTCR~~ and the capital resources needed to meet the overall financial adequacy rule. The PRA's approach to projecting the Pillar 2A component of capital requirements is described in ~~Chapter 9 in PRA Statement of Policy~~the PRA's draft SoP 'The PRA's methodologies for setting Pillar 2 ~~capital~~'.⁴⁵ ~~The PRA considers this approach to be appropriate~~capital for ~~most firms~~. The ~~firm~~Small Domestic Deposit Takers (SDDTs). The ~~SDDT~~ should make all these projections in a manner consistent with its risk management processes and systems as set out in ~~Internal Capital Adequacy Assessment 3.1~~. ICAA 3.1.

3.~~24-22~~ When deciding the planning horizon over which to conduct their analysis, ~~firms~~SDDTs should consider how long it might take to recover from any loss. The time horizon over which stress tests and scenario analyses should be carried out will depend on, among other things, the maturity and liquidity of the positions stressed. For example, ~~for~~ the market risk arising from the holding of investments, ~~this~~ will depend upon the extent to which there is a regular, open and transparent market in those assets, which would allow fluctuations in the values of the investments to be more readily and quickly identified.

3.~~25-23~~ In projecting its financial position over the relevant time horizon, ~~the firm~~an SDDT should:

- (i) reflect how its business plan would respond to the adverse events being considered, taking into account factors such as changing consumer demand and changes to new business assumptions;
- (ii) consider the potential impact on its stress testing of dynamic feedback effects and second-order effects of the major sources of risk identified in accordance with the overall Pillar 2 rule in ~~Internal Capital Adequacy Assessment~~ICAA 3.1;
- (iii) estimate the effects on its financial position of the adverse event without adjusting for management actions;
- (iv) separately, identify any realistic management actions that the ~~firm~~SDDT could, and would, take to mitigate the adverse effects of the stress scenario; and
- (v) estimate the effects of the stress scenario on its financial position after taking account of realistic management actions.

3.~~26-24~~ The PRA expects ~~firms~~SDDTs to identify any realistic management actions intended to maintain or restore capital adequacy. ~~A firm~~An SDDT should reflect management actions

⁴⁵ Available at <https://www.bankofengland.co.uk/prudential-regulation/publication/2015/the-pras-methodologies-for-setting-pillar-2-capital>.

in its projections only where it could, and would, take such actions, taking account of factors such as market conditions in the stress scenario and any effects upon the firm's reputation with its counterparties and investors. The combined effect on capital and retained earnings should be estimated.

3.27-25 To assess whether prospective management actions in a stress scenario would be realistic, and to determine which actions the ~~firm~~SDDT could and would take, the PRA expects ~~a firm~~an SDDT to take into account any preconditions that might affect the value of management actions as risk mitigants. It should then analyse the difference between the estimates of its financial position over the time horizon, both gross and net of management actions, in sufficient detail to understand the implications of taking different management actions at different times, particularly where they represent a significant divergence from the ~~firm's~~SDDT's business plan.

~~3.28 A firm should use the results of its stress testing and scenario analysis not only to assess capital needs, but also to decide if measures should be put in place to minimise the adverse effect on the firm if the risks covered by the stress or scenario test materialise. Such measures might be a contingency plan or more concrete and immediate risk mitigation steps.~~

Double leverage

~~3.29 Where a firm is a member of a group in which a qualifying parent undertaking⁴⁶ has a double leverage ratio above 100%, or is projecting one above 100%, the PRA expects the firm to assess and mitigate the risks of double leverage, including the cash-flow risks incurred by its qualifying parent undertaking as part of its stress testing and scenario analysis. For this purpose, 'double leverage ratio' is defined as a qualifying parent undertaking's common equity capital investment in its subsidiaries,⁴⁷ divided by its own common equity capital.~~

~~3.29A For purposes of calculating the double leverage ratio, 'qualifying parent undertaking's common equity capital investment in its subsidiaries' is defined as the holding company's investment in common equity of its subsidiaries. For the avoidance of doubt, investment in Additional Tier 1 instruments, calculated according to CRR Article 61, should not be included. For purposes of calculating the double leverage ratio, 'own common equity capital' is defined as shareholder's equity less intangible assets, less deferred tax assets (DTAs), less Additional Tier 1 Instruments.~~

~~(i) 'DTAs' has the same meaning as under the applicable accounting framework.~~

~~(ii) 'Intangible assets' has the same meaning as under the applicable accounting framework and includes goodwill.~~

~~(iii) Additional Tier 1 instruments should be calculated according to CRR Article 61.~~

~~(iv) 'Applicable accounting framework' refers to the accounting standards to which the institution is subject under Regulation (EC) No 1606/2002 or Directive 86/635/EEC.~~

3.30 These expectations also apply where the firm is a member of a group that uses a different definition of double leverage, or calculates double leverage in respect of a grouping

⁴⁶ Section 192B FSMA.

⁴⁷ As defined in Article 4(1) of CRR.

of companies,⁴⁸ and its double leverage ratio is over 100%, or is projected to be over 100%. In these circumstances, information should be provided in respect of the qualifying parent undertaking's double leverage ratio as set out above, as well as in respect of the aggregate double leverage ratio in those circumstances where double leverage occurs at different levels in the group, as set out above. Should the firm's own methodology differ from the one described in this document, it should provide information in respect of its own internal approach, as well as the approach described in this document.

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

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

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

3.33 Under the SMR,⁴⁹ firms are required to allocate a PR for managing the allocation and maintenance of the firm's capital, funding and liquidity to an individual performing an SMF.⁵⁰ The PRA expects:

- ☐ the SMF allocated this PR to ensure that the firm conducts the assessments specified in paragraphs 3.29 to 3.31 and to document them in the firm's ICAAP submissions; and

⁴⁸ For example the ultimate qualifying parent undertaking and a number of intermediate parent undertakings.

⁴⁹ See Rule 4.1(7) in the Allocation of Responsibilities part of the PRA Rulebook and PRA Supervisory Statement 28/15 'Strengthening individual accountability in banking', May 2017: <https://www.bankofengland.co.uk/prudential-regulation/publication/2015/strengthening-individual-accountability-in-banking-ss>.

⁵⁰ Typically the Chief Finance function (SMF2) or, depending on the organisational structure of a group, a Group Entity Senior Manager (SMF7).

- ☐ ~~firms to ensure this expectation is explicitly reflected in the relevant SMF's Statement of Responsibilities.~~

Draft for consultation

4. Reverse stress testing

~~4.1 This chapter on reverse stress testing was added to this supervisory statement on 3 August 2015 following consultation on proposals in CP17/15.⁵¹~~

~~4.2~~ 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~~ ICAA 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.

~~4.3~~ 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.

~~4.4~~ 3 The PRA may request ~~a firm~~ a firm ~~an SDDT~~ 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.

~~4.5~~ 4 In carrying out the stress tests and scenario analyses required by rule 15.2 of the ~~Internal Capital Adequacy Assessment~~ ICAA Part of the PRA Rulebook ~~a firm~~ a firm ~~an SDDT~~ should at least take into account each of the sources of risk identified in accordance with ~~Internal Capital Adequacy Assessment~~ ICAA 3.1.

~~4.6~~ 5 Reverse stress testing should be appropriate to the nature, size and complexity of the ~~firm's SDDT's~~ business and of the risks it bears. Where reverse stress testing reveals that ~~a firm's~~ the SDDT's risk of business failure is unacceptably high, the ~~firm~~ SDDT should devise realistic measures to prevent or mitigate the risk of business failure, taking into account the time that the ~~firm~~ SDDT would have to react to these events and implement those measures. As part of these measures, ~~a firm~~ the SDDT should consider if changes to its business plan are appropriate. These measures, including any changes to the ~~firm's SDDT's~~ business plan, should be documented as part of the results referred to in rule 15.4 of the ~~Internal Capital Adequacy Assessment~~ ICAA Part of the PRA Rulebook.

⁵¹ ~~PRA Consultation Paper CP17/15, 'The PRA Rulebook: Part 3', April 2015, <https://www.bankofengland.co.uk/prudential-regulation/publication/2015/the-pra-rulebook-part-3>.~~

4.76 In carrying out its reverse stress testing, ~~a firm~~the SDDT could consider scenarios in which the failure of one or more of its major counterparties or a significant market disruption arising from the failure of a major market participant, whether or not combined, would cause the ~~firm's business to fail. For an RFB, this supervisory statement should be read in conjunction with SS8/16~~⁵². ~~SS8/16 sets out the PRA's expectation that an RFB sub-group should consider the failure of group entities that are not members of the RFB sub-group as part of reverse stress testing~~SDDT's business to fail.

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

Draft for consultation

⁵² 'Ring-fenced bodies', November 2017: <https://www.bankofengland.co.uk/prudential-regulation/publication/2016/ring-fenced-bodies-ss>.

5. The Capital Supervisory Review and Evaluation Process (C-SREP)

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

- (i) arrangements, strategies, processes and mechanisms implemented by a firm's SDDT to comply with its regulatory requirements laid down in PRA rules ~~and the CRR~~; ~~risks that the firm poses to the financial system~~; risks to which the firm's SDDT is or might be exposed; and
- (ii) further risks revealed by stress testing.

5.2 -As part of the C-SREP, the PRA will review the firm's SDDT's ICAAP and have regard to the risks outlined in the overall Pillar 2 rule in Internal Capital Adequacy Assessment ICAAP 3.1, the firm's SDDT's vulnerabilities under reverse stress testing, the SDDT's 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's SDDT 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. 5.2A document. The PRA will consider whether it has reasonable grounds to suspect that money laundering or terrorist financing is being undertaken, or has been committed or attempted, or there is increased risk thereof in connection with that institution. If the PRA has reasonable grounds to suspect such activity or increased risk, it will take appropriate steps.

5.3- When the PRA reviews an ICAAP as part of the C-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's SDDT to submit the design and results of its reverse stress tests and any subsequent updates as part of its risk assessment.

5.5 -The C-SREP will also consider:

- ~~□ the results of stress tests carried out in accordance with the CRR by firms that use an internal ratings-based (IRB) approach or internal models for market risk capital requirements;~~
- (i) the exposure to, and management of, concentration risk by firm's SDDT, including their compliance with the requirements set out in ~~Part Four of the CRR and~~ Chapter 6 of the ICAA rules;

- (ii) the robustness, suitability and manner of application of policies and procedures implemented by ~~firms~~the SDDT for the management of the residual risk associated with the use of credit risk mitigation techniques;
- (iii) the extent to which the capital held by ~~firms~~the SDDT in respect of assets which it has securitised is adequate, having regard to the economic substance of the transaction, including the degree of risk transfer achieved;
- (iv) the exposure and management of liquidity risk by ~~firms~~the SDDT, including the development of alternative scenario analyses, the management of risk mitigants (including the level, composition and quality of liquidity buffers), and effective contingency plans;
- (v) the impact of diversification effects and how such effects are factored into ~~firms'~~the SDDT's risk measurement ~~system;~~systems;
- (vi) the geographical location of ~~firms'~~the SDDT's exposures;
- ~~□ risks to firms arising from excessive leverage;~~
- (vii) whether ~~a firm~~the SDDT has provided implicit support to a securitisation; ~~and~~
- (viii) the exposure to and management of foreign currency lending risk to unhedged retail and SME borrowers by firms, ~~in line with Title 6, section 2 paragraphs 158–59 of the EBA's Guidelines on common procedures and methodologies for the SREP;~~⁵³;
- (ix) the extent to which the allocation of the total amount of financial resources, own funds and internal capital between different parts of the consolidation group reflects the nature, level, and distribution of the risks to which the consolidation group is subject; ~~and,~~
- (x) the extent to which any capital requirements or buffers set on an entity established outside the United Kingdom, on an individual or sub-consolidated basis, exceed the requirements or buffers applicable at the consolidated group level to cover the same risk; ~~and,~~
- ~~□ where a firm is a member of a group in which a qualifying parent undertaking has a double leverage ratio above 100%, or is projecting one above 100%, the extent to which the firm is managing the risks of double leverage, and the credibility of its related stress testing and scenario analysis.~~

~~5.5A Where groups contain an RFB sub-group, the SREP will also consider RFB group risk.~~

~~5.6 The PRA also assesses as part of the SREP the risks that the firm poses to the financial system.~~

⁵³ ~~See footnote (1) on page 14.~~

~~5.7~~ 5.6 The PRA may need to request further information and meet with the management body and other representatives of a firm's SDDT in order to evaluate fully the comprehensiveness of the ICAAP and the adequacy of the governance arrangements around it. The management body should be able to demonstrate an understanding of the ICAAP consistent with its taking responsibility for it. And the appropriate levels of the firm's SDDT's management should be prepared to discuss and defend all aspects of the ICAAP, covering both quantitative and qualitative components.

~~5.8~~ [Deleted]

~~5.8A In applying the principle of proportionality to the SREP, the PRA adheres to the approach in section 2.4 of the EBA Guidelines on common procedures and methodologies for the SREP which relates the frequency and intensity of the SREP to firms' nature, scale and complexity. The PRA categorises firms according to their significance to the stability of the UK financial system, in accordance with the criteria set out in 'The PRA's approach to banking supervision'.⁵⁴ The PRA has additional criteria for applying the principle of proportionality to particular aspects of the SREP:~~

- ~~□ Smaller firms have fewer reporting requirements under the Pillar 2 reporting part of the Rulebook.⁵⁵~~
- ~~□ A proportionate approach is applied to the operational risk Pillar 2A add-for non-Category 1 firms.~~
- ~~□ The PRA provides more proportionate scenarios for smaller firms' own stress testing. For example, the approach applied to the PRA buffer for new banks takes into account their recent entry to the market.⁵⁶~~

~~5.9~~ 7 On the basis of the C-SREP, the PRA will determine whether the arrangements implemented by a firm's SDDT and the capital held by it provide sound management and adequate coverage of its risks. If necessary, the PRA will require the firm's SDDT 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~~ 8 There are two main areas that the PRA considers when assessing a firm's SDDT's capital adequacy under a C-SREP: (i) risks to the firm's SDDT which are either not captured, or not fully captured, under the CRRPRA Rulebook (eg. IRRBB and concentration risk); and (ii) risks to which the firm's SDDT may become exposed over a forward-looking planning horizon

⁵⁴ Paragraph 32 <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/approach/banking-approach-2018.pdf>

⁵⁵ Rule 2.3 of the Pillar 2 Part of the PRA Rulebook

⁵⁶ Non-systemic UK banks: The Prudential Regulation Authority's approach to new and growing banks <https://www.bankofengland.co.uk/prudential-regulation/publication/2020/new-and-growing-banks>

~~(eg due to changes to the economic environment).~~ The PRA refers to the first area as Pillar 2A and the second as Pillar 2B.

5.11-9 To assess the capital adequacy of ~~a firm~~ an SDDT under Pillar 2A, the PRA has developed capital methodologies. The methodologies are published in ~~PRA Statement of Policy, the PRA's draft SoP~~ 'The PRA's methodologies for setting Pillar 2 ~~capital~~'. capital for Small Domestic Deposit Takers (SDDTs).

5.12-10 The PRA will set Pillar 2A capital requirements ~~in light of both the calculations included in a firm's ICAAP and the results of the PRA's taking into consideration its own Pillar 2A methodologies. In considering the level of capital that is necessary to capture risks to which the firm is or might be exposed, the PRA also takes into account the extent to which those risks are mitigated by macroprudential buffers. and using an SDDT's ICAAP as an input where judged appropriate.~~ Setting a Pillar 2A capital requirement ~~is~~ may be subject to peer group reviews to help ensure consistency of decisions across firms.

5.12A ~~Paragraphs 5.12A to 5.12C are no longer applicable from 1 January 2026, except for Interim Capital Regime (ICR) firms and ICR consolidation entities. These paragraphs may be applicable to relevant ICR firms and ICR consolidation entities until 1 January 2027. For firms using the standardised approach (SA) for credit risk, the PRA will assess whether the capital held by them exceeds the amount necessary to ensure a sound management and coverage of their risks. To this end, the PRA will make an overall assessment of the adequacy of capital, taking into account the outcome of the application of the PRA's own Pillar 2A methodologies, the firm's ICAAP, business model, and whether the firm is considered relatively low-risk and well-managed. The PRA will also conduct a peer group review, including with those firms that use the IRB approach, by using the upper range of the credit risk IRB benchmarks which are set out in the Statement of Policy 'The PRA's methodologies for setting Pillar 2 capital'.~~⁵⁷

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

5.12C ~~For firms using IFRS 9, the PRA will also consider the extent to which expected credit losses, over a twelve month period, are covered by the Pillar 1 charge under the SA, to inform the setting of Pillar 2A capital requirements.~~

5.13-5.11 ~~The PRA will review the firm's records referred to in Internal Adequacy Assessment 13.1 as part of its~~ The PRA will review the SDDT's records referred to in ICAA 13.1 as part of its C-SREP to judge whether a firm will be able to continue to meet its CRR requirements and

⁵⁷ October 2017: <https://www.bankofengland.co.uk/prudential-regulation/publication/2015/the-pras-methodologies-for-setting-pillar-2-capital>.

the overall financial adequacy rule in [Internal Capital Adequacy Assessment ICA](#) 2.1 throughout the time horizon used for the capital planning exercise.

The setting of Pillar 2A capital requirements and the **PRA buffer** **Single Capital Buffer**

Pillar 2A Capital Requirements

5.14-12 Following the [C-SREP](#), including both a review of the ICAAP and any further interactions with ~~the firm~~[each SDDT](#), the PRA will normally set ~~the firm~~ a Pillar 2A capital requirement [for the SDDT](#) on an individual basis, for the amount and quality of capital that the PRA considers the firm should hold, in addition to the capital it must hold to comply with the [CRRPRA Rulebook](#) (Pillar 1 capital) to meet the overall financial adequacy rule in [Internal Capital Adequacy Assessment 2.1. ICA](#) 2.1. The PRA will additionally set Pillar 2A capital requirements for ~~firms~~[SDDT consolidation entities](#) which must comply with the overall financial adequacy rule in [Internal Capital Adequacy Assessment ICA](#) 2.1 on a consolidated basis ~~and, where groups contain an RFB sub-group, on a sub-consolidated basis.~~

~~5.15 In many cases the PRA may decide to set Pillar 2A capital requirements on an individual basis by undertaking a detailed individual assessment, calculating the relevant Pillar 2A add-ons according to the individual firm's risk profile. Alternatively, the PRA may decide to set Pillar 2A capital requirements on an individual basis calibrated so that its TCR represents a share of the UK consolidated group or sub-consolidated group (where relevant) TCR where the firm is able to demonstrate that capital has been adequately allocated among subsidiaries, the members of the group or RFB sub-group are strongly incentivised to support each other, and there are no impediments to the transfer of capital within the group or RFB sub-group. Where a firm is not considered to have significant systemic impact, or where it has a very similar risk profile to the UK consolidation group (or RFB sub-consolidation group), the PRA may decide to set Pillar 2A on an individual basis by applying the same Pillar 2A add-on rate as calculated for the UK consolidated (or RFB sub-consolidated) Pillar 2A capital requirement to the individual total RWAs of the firm.~~

5.16-13 Where the PRA sets a firm-specific Pillar 2A capital requirement, it will generally specify an amount of capital (Pillar 2A) that the [firm SDDT](#) should hold at all times in addition to the capital it must hold to comply with the [CRRPRA Rulebook](#) (Pillar 1). It will usually do so by stating that the [firm SDDT](#) should hold capital of an amount equal to a specified percentage of the firm's Pillar 1 RWAs (the total risk exposure amount calculated in accordance with [Article 92\(3\) of the CRRPRA Rulebook](#)), plus one or more static add-ons in relation to specific risks in accordance with the overall Pillar 2 rule in [Internal Capital Adequacy Assessment ICA](#) 3.1. The PRA requires [firms SDDTs](#) to meet Pillar 2A with at least 56.25% CET1 capital, no more than 43.75% additional Tier 1 (AT1) capital and no more than 25% Tier 2 [capital](#). For these purposes, firms should follow the provisions on the

definition of capital set out in the Definition of Capital Part of the PRA Rulebook and ~~Supervisory Statements~~supervisory statement 7/13.⁵⁸

~~5.1714~~ It is for firms to ensure that they SDDTs must comply with the overall financial adequacy rule in ~~Internal Capital Adequacy Assessment~~ICAA 2.1. If ~~a firm~~an SDDT holds the level of capital required under its TCR, that does not necessarily mean that it is complying with the overall financial adequacy rule. ~~Deviation by a firm from~~Falling below the ~~terms~~level of ~~the Pillar 2A and~~capital required under TCR ~~given to it by the PRA~~ does not automatically mean that the firm is in breach of the overall financial adequacy rule or that the PRA will consider the ~~firm~~SDDT is failing, or likely to fail, to satisfy the Threshold Conditions (TCs). However, firms should expect the PRA to investigate whether any firm is failing, or likely to fail, to satisfy the TCs, with a view to taking further action as necessary.

~~5.1815~~ Under the Capital Buffers Part of the PRA Rulebook, ~~The PRA expects a firm not to meet the CRD buffers with any CET1 capital maintained to meet its TCR. a firm if an SDDT~~ agrees with its TCR, the PRA will expect the ~~firm~~SDDT to apply for a requirement under section 55M of the Financial Services and Markets Act 2000 (FSMA) to set the amount and quality of the Pillar 2A capital requirement ~~and prevent the firm from meeting any of the CRD buffers that apply to it with any CET1 capital maintained to meet Pillar 2A.~~ The ~~firm~~SDDT will normally be invited to apply for such a requirement at the same time as it is advised of its proposed Pillar 2A capital requirement. If a firm does not apply for such a requirement the PRA will consider using its powers under section 55M(3) to impose one of its own initiative.

Pillar 2B Single Capital Buffer

~~5.19~~ [Deleted]

~~The PRA buffer~~

~~5.2016~~ Following the C-SREP, the PRA will also notify ~~the firm~~each SDDT of an amount of capital that it should hold as a ~~PRA buffer~~SCB, over and above the level of capital required to meet its TCR ~~and over and above the CRD buffers. The PRA buffer. The SCB~~, based on a firm-specific supervisory assessment, should be of a sufficient amount to allow the firm to continue to meet the overall financial adequacy rule in ~~Internal Capital Adequacy Assessment~~2.1. ICAA 2.1. This should be the case even in adverse circumstances, after allowing for realistic management actions that ~~a firm~~the SDDT could, and would, take in a stress scenario.

~~5.2117~~ In setting ~~a PRA buffer~~the SCB for ~~a firm~~an SDDT, the PRA will not just consider whether the ~~firm~~SDDT would meet its CET1 ~~capital requirements under the CRR and its TCR~~ (Pillar 1 and Pillar 2A capital requirement) in the non-cyclical stress scenario. Other factors

⁵⁸ –PRA ~~Supervisory Statements~~supervisory statement 7/13, '~~CRD IV and capital~~Definition of capital (CRR Firms)', December 2013: <https://www.bankofengland.co.uk/prudential-regulation/publication/2013/crdiv-and-capital-ss>.

informing the size of the ~~PRA buffer~~SCB include but are not limited to: the maximum change in capital resources and requirements under the stress; The PRA's expectations for Pillar 2B of new and growing banks are set out in the firm's leverage ratio; SS3/21 'Non-systemic UK banks: The PRA's approach to new and growing banks'.

5.18 The SCB will be set at a level no lower than 3.5% of each SDDT's RWAs before considering the extent to which Risk Management and Governance (RMG) assessment. This level will support the firm has used up its CRD buffers (eg resilience of SDDTs, on average across SDDTs and through the systemically important financial institution (SIFI) and capital conservation buffers); Tier 1 and total capital ratios; and the extent to which potentially significant risks are not captured fully as part of the stress cycle.

5.22-19 Where the PRA assesses a firm's risk management and governance (RMG) to be significantly weak, it may also ~~set~~adjust the ~~PRA buffer~~SCB to cover the risks posed by those weaknesses until they are addressed. This will generally be calibrated in the form of a scalar applied to the amount of CET1 required to meet the firm's TCR. The scalar could be to up to 40% of the total CET1 TCR ~~(variable)~~. If the PRA sets the ~~PRA buffer~~SCB to cover the risk posed by significant weaknesses in risk management and/or governance or applies a suspended scalar,⁵⁹ the PRA will identify those weaknesses to the ~~firm~~SDDT and expect the ~~firm~~SDDT to address those weaknesses within an appropriate timeframe. Once the identified weaknesses have been remedied, the PRA will remove the scalar. If new weaknesses emerge that are not adequately addressed by the scalar or if remedial action taken by the ~~firm~~SDDT has led to its removal a new scalar may be applied.

5.23-20 Where the PRA sets ~~a PRA buffer~~an SCB it will generally do so stating that the ~~firm~~SDDT should hold capital of an amount equal to a specified percentage of the ~~firm's SDDT's~~ Pillar 1 RWAs ~~(the total risk exposure amount calculated in accordance with Article 92(3) of the CRR)~~. The PRA expects ~~firms~~SDDTs to meet the ~~PRA buffer~~SCB with 100% CET1. The PRA expects ~~firms~~an SDDT not to meet the ~~PRA buffer~~SCB with ~~additional CET1 capital to the~~any CET1 capital maintained to meet its ~~CRD buffers~~TCR.

5.24-21 The PRA may set ~~a firm's PRA buffer~~an SDDT's SCB either as an amount of capital which it should hold from the time of the PRA's notification following the firm's C-SREP or, in exceptional cases, as a forward-looking target that ~~a firm~~the SDDT should build up over time. The SCB will apply at each level of consolidation which applies to an SDDT. Where the general stress and scenario testing rule, as SDDT is not part of the ICAAP rules, applies to a firm on a consolidated and/or sub-consolidated basis the PRA may notify the firm that it should hold a PRA buffer on a consolidated and/or sub-consolidated basis (as applicable). The PRA may in certain circumstances notify a firm that it should hold a PRA buffer a group

⁵⁹ Depending on the severity of the weaknesses identified and the proposed remediation actions, the PRA may allow the firm time to address the identified weaknesses before applying a scalar. In these circumstances, the PRA may give the firm an indicative figure for the size of the scalar – which is referred to as a 'suspended scalar'.

with an SDDT consolidation entity, the PRA will set the SCB on an individual basis; and where the SDDT is a subsidiary of an SDDT consolidation entity, the PRA will set the SCB both on an individual basis and consolidated level. In all cases, the PRA will set the SCB at a level no lower than 3.5% of the RWAs for the entity or group, as relevant, before the RMG assessment. PRA's expectations over the level of application of the SCB are set in the draft SoP 'The PRA's methodologies for setting Pillar 2 capital for Small Domestic Deposit Takers (SDDTs).'

5.25-22 If a firmthe SDDT, instead, considers that the proposed Pillar 2A ~~capital requirement~~ or the ~~PRA buffer~~SCB advised to it by the PRA is inappropriate to its circumstances it should notify the PRA of this, consistent with Fundamental Rule 7.⁶⁰ If, after discussion, the PRA and the ~~firm~~SDDT do not agree on an adequate level of capital, the PRA may consider using its own initiative powers under section 55M of FSMA to impose a requirement on the firm to hold capital in accordance with the PRA's view of the capital necessary to comply with the overall financial adequacy rule in ~~Internal Capital Adequacy Assessment 2.1~~ICAA 2.1. In deciding whether it should use its powers under section 55M, the PRA will take into account the amount of capital that the firm should hold for its ~~PRA buffer~~SCB.

~~5.25ZA The PRA's expectations for Pillar 2B of new and growing banks are set out in the SS3/21 'Non-systemic UK banks: The PRA's approach to new and growing banks'.⁶¹~~

~~Application of the PRA Buffer for subsidiaries of UK consolidation groups or RFB sub-groups
5.25A When setting the PRA buffer on an individual basis, the PRA's standard approach is to undertake a full assessment on the individual basis. Where the firm is part of a UK consolidation group or RFB sub-group (ie 'a subsidiary'), the PRA will set the PRA buffer in a similar way to the PRA approach to setting Pillar 2A capital requirements on an individual basis.⁶² The approach depends upon: the transferability of group resources; the nature and extent of integration of the subsidiary; the likelihood of group support; and the significance of the entity and the risk profile of its business relative to the group.~~

~~5.25B The PRA's framework for applying the PRA buffer to subsidiaries takes the group-level PRA Buffer assessment as a starting point.~~

~~5.25C The PRA may set the PRA buffer for a subsidiary such that, when aggregated with the TCR and combined buffer, the total capital it is expected to hold is the same as the internal capital the firms determines in its internal capital assessment to be sufficient. Where the sum of TCR and combined buffer exceeds the capital the firm has determined in its internal assessment, the PRA expects to set a PRA Buffer of zero. Internal capital must be sufficient to cover all the risks to which it is exposed and to absorb potential losses from stress scenarios. Subject to supervisory judgement, this will be the case when the following conditions are met:~~

⁶⁰ Fundamental Rule 7: A firm must deal with its regulators in an open and cooperative way and must disclose to the PRA appropriately anything relating to the firm of which the PRA would reasonably expect notice.

⁶¹ April 2021: <https://www.bankofengland.co.uk/prudential-regulation/publication/2020/new-and-growing-banks>

⁶² Paragraphs 5.14 and 5.15 of SS31/15.

- ☐ on a UK consolidated basis, the PRA buffer plus combined buffers and TCR is the same as the internal capital the group considers to be adequate (eg, when the PRA buffer is zero and the group considers regulatory requirements for capital are sufficient); and
- ☐ on an individual basis, the PRA has not identified it as having materially different capital needs in a medium-term stress, or to be exposed to materially different risks, to those of the group.

5.25D The PRA may also calibrate the PRA buffer on an individual basis in this way where these conditions are not met but the firm is not considered to be material to its consolidation group or RFB sub-group, and the PRA considers financial resources to be transferable between the group entities and judges the parent to be likely to support a failing subsidiary. A subsidiary is considered not material if it comprises less than 5% of the UK consolidation group RWAs, leverage exposures and operating income.

5.25E Where a firm has a very similar risk profile to its consolidation group or RFB sub-group (for example, where a subsidiary comprises more than 80% of the UK consolidation group's RWAs and the rest of the group undertakes similar activities as the subsidiary), the PRA may decide to set the PRA buffer on an individual basis by reference to the UK consolidated (or RFB sub-consolidated) PRA buffer calculation. Where consolidated or sub-consolidated PRA buffer calculations include add-ons for group risk, these will not be included in the calculation of the subsidiary's PRA buffer.

5.25F The PRA will set the PRA buffer according to a comprehensive individual assessment if none of the above approaches is applicable. The PRA may also set the PRA buffer according to the full assessment process where a supervisor identifies any factors that mean the above approach is not appropriate, such as:

- ☐ material impediments to the transferability of capital within the group;⁶³
- ☐ the subsidiary is a specialist subsidiary containing a high concentration of a group's business that could lead to a negative outcome in a stress, but this concentration is offset at a group-wide level;
- ☐ there are significant weaknesses in the risk management or governance of the subsidiary;
- ☐ the subsidiary has significant weaknesses that call into question the adequacy of existing capital requirements; or
- ☐ other material supervisory concerns lead the supervisor to consider the firm's internal capital to be insufficient.

Transitional arrangements

5.26 [Deleted]

5.27 [Deleted]

5.28 [Deleted]

⁶³ As defined in SS 31/15 — Paragraphs 5.20 to 5.24.

~~5.29 [Deleted]~~

~~5.30 [Deleted]~~

Failure to meet TCR and use of the ~~PRA buffer~~ Single Capital Buffer

~~5.31-23~~ The PRA expects every ~~firm~~SDDT to hold at least the level of capital ~~it is~~ required to meet its TCR at all times. If ~~a firm's~~an SDDT's capital has fallen or is expected to fall below that level it should inform the PRA as soon as practicable explaining why this has happened or is expected to happen. The ~~firm~~SDDT will also be expected to discuss the actions that it intends to take to increase its capital and/or reduce its risks (and therefore capital requirement), and any potential modification that it considers should be made to the Pillar 2A capital requirement.

~~5.32-24~~ Where this has happened, the PRA may ask ~~a firm~~the SDDT for alternative and more detailed proposals or further assessments of capital adequacy and risks faced by the ~~firm~~SDDT. The PRA will seek to agree with the ~~firm~~SDDT the appropriate timescales and the scope for any such additional work.

~~5.33-25~~ ~~Use of the PRA buffer is not itself a breach of capital requirements or TCRs. The PRA expects firms~~ SDDTs are expected and encouraged to use their ~~PRA buffer (and indeed other capital buffers⁶⁴) in times of~~ SCB to manage a stress. ~~Use of buffers (including both the combined buffer and PRA buffer) are what firms and the PRA model as part of their stress tests. The PRA does not expect or require firms to finance themselves with more capital than the total of their regulatory requirements and buffers. However, where a firm has a PRA buffer in place, it~~ SDDTs should not use that buffer~~the SCB~~ in the normal course of business or enter into it as part of its base business plan. ~~5.34 Consistent with~~ In a scenario where an SDDT has identified the need to draw down on its SCB, and in line with Fundamental Rule 7, a firm~~the SDDT~~ should notify the PRA as early as possible ~~where it has identified that it would need to use its PRA buffer (even if the firm has not accepted the PRA's assessment of the amount of capital required for the PRA buffer). The firm's notification should state as a minimum:~~

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

~~5.35~~ ~~A firm~~. An SDDT which does not meet its ~~PRA buffer~~SCB can expect enhanced supervisory ~~action~~scrutiny and should prepare a capital restoration plan⁶⁵. ~~If the PRA is satisfied with the rationale presented, the PRA will be content. The PRA's expectations on the use of the SCB are set in the draft SoP 'The PRA's methodologies for setting Pillar 2 capital' for firms to rebuild their buffers over a reasonable period of time. In exercising its~~

⁶⁴ ~~Refer to SS6/14 'Implementing CRD IV: Capital buffers' for details on the use of the capital buffers: <https://www.bankofengland.co.uk/prudential-regulation/publication/2014/implementing-crd-iv-capital-buffers-ss>~~

⁶⁵ ~~Where a firm does not meet its combined buffer it must do so as a part of a capital conservation plan including the information in Capital Buffers 4.5.~~

~~judgement on what constitutes a reasonable time to rebuild the PRA buffer (and potentially other capital buffers) and other potential supervisory action, the PRA will take into account how far the firm has run into its buffers, the expected duration of the stress, the drivers of that stress, the context of that stress (whether firm-specific or systemic) and macroeconomic and financial conditions. If the PRA is not satisfied with the capital restoration plan or with the firm's reasons for using the buffer it may consider using its powers under section 55M of FSMA to require the firm to raise sufficient capital to meet the buffer within an appropriate timeframe. Small Domestic Deposit Takers (SDDTs).~~

~~5.36 The automatic distribution constraints associated with the CRD buffers do not apply to the PRA buffer.~~

Disclosure

~~5.3726 Firms SDDTs should disclose the PRA's SREP feedback letter setting Pillar 2A capital requirements and, where applicable, the PRA buffer SCB to their auditors. The PRA expect firms SDDTs to publicly disclose the amount and quality of TCR which apply to them at the highest level of consolidation in the UK. The PRA also expects RFBs to disclose their TCR on a sub-consolidated basis where an RFB sub-group is established. In those circumstances in which Pillar 2A has not been set as a requirement, the PRA expects firms to disclose their total Pillar 1 plus Pillar 2A capital guidance. Otherwise, the PRA expects firms to treat all other information relating to TCR, including details of its constituent parts, and all information relating to the PRA buffer, as confidential unless they are required to disclose it by law. If firms~~ The PRA expects the SCB to be treated as confidential unless it is required to be disclosed by law. If SDDTs wish to disclose the PRA's SREP feedback letter or any part of it to any third parties (other than their auditors) they should, consistent with Fundamental Rule 7, provide appropriate prior notice to the PRA of the proposed form, timing, nature and purpose of the disclosure.

~~5.3827~~ Where an immediate market disclosure obligation exists, prior notification to the PRA should not lead to any delay in disclosure. But any firm SDDT intending to disclose information relating to TCR (except the total figure) or the buffers SCB should (consistent with Fundamental Rule 7), where reasonably practicable, provide appropriate notice in advance of the proposed disclosure and the reasons for it. The PRA does not advise firms SDDTs on their market disclosure obligations and firms SDDTs should seek their own advice on this matter. The FCA is responsible for oversight of issuers' compliance with their market disclosure obligations.

Draft for consultation

Annex – ICAAP Optional Structure

The ICAAP is owned by the firm and it is therefore for the firm to decide how best to structure the document. The below optional structure has been produced by the PRA in order to aid SDDTs in structuring their ICAAP, should they choose to use it. There is no expectation that firms use this structure; doing so is entirely optional.

Further, it is the responsibility of the SDDT to include all relevant risks in their ICAAP. The below optional structure is not exhaustive and responsibility for ensuring the ICAAP document is comprehensive remains with the Board.

Small Domestic Deposit Takers (SDDTs) can cross-reference existing documents where possible and are therefore not required to duplicate information provided in other regulatory documents such as the Corporate Strategy, Internal Liquidity Adequacy Assessment Process (ILAAP), or Recovery Plan.

<u>Section</u>	<u>Guidance</u>
<u>1. Executive Summary</u>	<ul style="list-style-type: none"> <u>• Provide a summary of the SDDT's total capital requirements, Single Capital Buffer and capital position.</u> <u>• Provide a summary of actions raised and taken since the last ICAAP, PRA visit or internal auditor meeting. Detailed information can be included in the annex.</u>
<u>2. Business overview</u>	<u>To meet relevant expectations, the SDDT should use this section to provide key background information on its business activities, strategy and forward planning.</u>
<u>3. ICAAP governance</u>	<p><u>This section should outline the SDDT's ICAAP construction and approval process, as well as key challenges and the governance overview.</u></p> <p><u>The SDDT can use this section to outline the following process.</u></p> <ul style="list-style-type: none"> <u>• ICAAP approach:</u> <ul style="list-style-type: none"> <u>- The process that the SDDT has followed when conducting its internal capital adequacy assessment.</u> <u>- The support the ICAAP can or does provide to the SDDT's strategic planning and business decisions.</u> <u>- Future enhancement planned to the ICAAP.</u> <u>• ICAAP construction, challenges and approval:</u> <ul style="list-style-type: none"> <u>- The process of designing the scenarios used in the ICAAP; how the scenarios were chosen and why they are considered appropriate.</u>

Section	Guidance
	<ul style="list-style-type: none"> - <u>How the stress testing is linked to the SDDT's risk appetite and how the SDDT uses the stress testing outcome to inform its risk management function.</u> - <u>The Board confidence level about the accuracy of the ICAAP in quantifying the risks that the SDDT faces.</u> - <u>The ICAAP document approval process, including the discussion, debate and challenge on relevant issues. Board members' challenge or review committee minutes can be included in the annex.</u>
<u>4. Capital requirements</u>	
<u>4.1. Pillar 1 assessment</u>	<p><u>The SDDT should describe the methodologies used in assessing its Pillar 1 requirements.</u></p> <p><u>For credit risk, the SDDT should provide a breakdown of its Pillar 1 lending, risk weights and resulting RWAs. The firm is expected to provide further detail if the figures do not directly align with the CRR risk weight.</u></p> <p><u>For operational risk, the SDDT should describe the approach it used to calculate its P1 operational risk capital requirement and resulting operational RWAs.</u></p> <p><u>The SDDT can include a forecast of how its RWAs, and Pillar 1 requirements are expected to change over the coming period and the reasoning behind those expected changes.</u></p> <p><u>The SDDT is expected to provide further detail on any subjectivity or judgement involved in the Pillar 1 assessment.</u></p>
<u>4.2 Pillar 2A Assessment</u>	<p><u><i>This section should set out the firm's own identification, assessment and (where relevant) quantification of Pillar 2A risks to ensure that capital requirements are adequate, for the purpose of meeting both the PRA rulebook and the expectations set out in supervisory statements [XX/XX], and informing the PRA's Pillar 2A capital setting.</i></u></p> <p><u>The SDDT should assess the major sources of risk to the firm's ability to meet its liabilities as they fall due. In particular, a firm's Pillar 2A assessment should focus on the risks to the firm which are either not captured, or not fully captured, under Pillar 1 requirements.</u></p> <p><u>The SDDT is only required to assess risk drivers that it is or might be exposed to, including, without limitation, those set out in Article 3.3 of the Internal Capital Adequacy Assessment Part of the PRA Rulebook and those listed below. For relevant risk drivers, the SDDT should explain how the risk has been captured with reference to the PRA's expectations and how the outcome informed the firm's capital planning.</u></p>

Section	Guidance
	<p><u>No assessment is necessary for risk drivers that are not relevant to the SDDT's business model; for example, an SDDT with no trading book and market exposure will not need to assess its market risk. Where an SDDT has identified risks as not being material, it should provide evidence of the assessment process that determined this and discuss why that conclusion has been reached.</u></p> <p><u>The SDDT should provide justification of the methodologies used in its Pillar 2A assessment and how the methodologies are proportionate to the nature, scale and complexity of the SDDT's operation.</u></p> <p><u>Liquidity risk should also be assessed in this section where relevant including in relation to potential losses arising from the liquidation of assets and increases in the cost of funding during periods of stress. The SDDT should reference its ILAAP where relevant and does not need to produce a standalone liquidity assessment for the purpose of the ICAAP. However, If the ILAAP highlights liquidity concerns, SDDTs should build on this analysis to consider how liquidity risks could lead to potential losses and capital adequacy implications.</u></p> <p><u>Credit risk:</u></p> <p><u>Credit concentration risk:</u></p> <p><u>IRRBB:</u></p> <p><u>Operational risk:</u></p> <p><u>Counterparty credit risk:</u></p> <p><u>Pension obligation risk:</u></p> <p><u>Exposure to securitisations:</u></p> <p><u>Financial risks from climate change:</u></p> <p><u>Other risks:</u></p> <p><u>The SDDT should assess other risks it is exposed to, and must explain how the risk has been captured in each stress testing scenario and how the outcome informed the SDDT's capital planning.</u></p>

Section	Guidance
<p><u>4.3. Capital planning, stress testing and the single capital buffer.</u></p>	<p><u>The purpose of P2B stress testing is to analyse the impact of a severe but plausible scenario and how the SDDT would respond. The SDDT should also outline its stress testing and scenario analysis policies and procedures in the ICAAP.</u></p> <p><u>The PRA has published common stress scenarios that can serve as the basis for SDDTs' ICAAP stress test (either directly or as a severity benchmark).</u></p> <p><u>The SDDT is expected to project its capital resources and capital requirements over a three-to-five-year horizon, taking account of its business plan and the impact of relevant adverse scenarios. In making the estimate, the SDDT should consider both the capital resources required to meet its capital requirements under the CRR and the capital resources needed to meet the overall financial adequacy rule.</u></p> <p><u>The SDDT should describe the following:</u></p> <ul style="list-style-type: none"> - <u>Scenario design and governance</u> - <u>Base case projections</u> - <u>Adjustments and assumptions made under stress</u> - <u>Stress impact before management actions</u> - <u>Identified BAU and Strategic Management Actions</u> - <u>Overall stress impact.</u>
<p><u>5. Reverse stress testing</u></p>	<p><u>The purpose of reverse stress testing is to increase the SDDT's awareness of its business model vulnerabilities. The SDDT should carry out qualitative stress tests and scenario analyses that test its business plan to failure taking into account each of the sources of risk identified.</u></p> <ul style="list-style-type: none"> • <u>In carrying out its reverse stress testing, the SDDT could consider scenarios in which the failure of one or more of its major counterparties or a significant market disruption arising from the failure of a major market participant, whether or not combined, would cause the SDDT's business to fail.</u> • <u>The SDDT should describe the scenario and the stress testing approach that is appropriate to the nature, size and complexity of the SDDT's business and of the risks it bears. Quantitative analyses are not expected to be included in the ICAAP but the PRA may still request that SDDTs quantify the level of financial losses that would place them in a situation of business failure should a scenario crystallise.</u>
<p><u>Annex</u></p>	
<p><u>1. Key financial update.</u></p>	<ul style="list-style-type: none"> • <u>The firm can use this section to present and provide commentary on its recent financial performance and balance sheet evolution.</u>

<u>Section</u>	<u>Guidance</u>
	<ul style="list-style-type: none">• <u>The firm can also use this section to forecast future profit/loss and balance sheet changes and explain how future financial performance can be achieved with its corporate strategies.</u>
<u>2. Actions raised in the latest capital SREP; PRA visits; or internal auditor meetings.</u>	<ul style="list-style-type: none">• <u>Detailed description of issues raised in the latest C-SREP, PRA visits or internal auditor meetings and actions that the firm has taken to address these issues.</u>
<u>3. Minutes related to ICAAP document</u>	<ul style="list-style-type: none">• <u>Minutes from governance committees where a final and near-final version of the ICAAP was recommended for approval or approved. The firm should include detailed description of challenges raised in the committee meeting.</u>