

Bank of England PRA

Appendix 2: The PRA's methodologies for setting Pillar 2 capital for Small Domestic Deposit Takers (SDDTs)

Draft statement of policy

September 2024

Draft for consultation



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Introduction

1.1 This statement of policy (SoP) is relevant to Prudential Regulation Authority (PRA) regulated banks, building societies, and consolidation entities that meet the criteria to become a Small Domestic Deposit Taker (SDDT) or an SDDT consolidation entity.¹ It sets out the methodologies that the PRA uses to inform the setting of Pillar 2 capital for all SDDTs. For these firms, it replaces PRA SoP – The PRA’s methodologies for setting Pillar 2 capital.² For ease of reading, any references in relation to an SDDT hereafter in this SoP should be treated as applicable to both an SDDT and an SDDT consolidation entity, unless stated otherwise.

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

1.3 Section II: Pillar 2B provides information on the purpose of the Single Capital Buffer for SDDTs and how it is determined. Section II also provides details on the PRA’s approach to tackling weak governance and risk management for SDDTs under Pillar 2B.

1.4 Firms are required by the Reporting Pillar 2 Part of the PRA Rulebook, or may be asked, to submit data to inform the PRA’s approach to setting Pillar 2A capital requirements. Data may be requested on an individual, consolidated and/or sub-consolidated basis as applicable.

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 Part of the PRA Rulebook.

² July 2021: <https://www.bankofengland.co.uk/prudential-regulation/publication/2015/the-pras-methodologies-for-setting-pillar-2-capital>.

Section I: Pillar 2A methodologies

2 Credit risk

2.1 This chapter sets out the methodology the PRA uses to inform the setting of an SDDT's Pillar 2A capital requirement for credit risk.

Definition and scope of application

2.2 Credit risk is the risk of losses arising from a borrower or counterparty failing to meet its obligations as they fall due.

2.3 SDDTs' Pillar 1 capital requirements for credit risk are determined in accordance with the Credit Risk: Standardised Approach (CRR) Part of the PRA Rulebook.³ However, the PRA considers that the Pillar 1 credit risk standardised approach may not capture all credit risks to which a firm is exposed and there are idiosyncratic risks faced by certain SDDTs that may require additional capital. The PRA therefore assesses credit risk as part of its Pillar 2 review of SDDTs' capital adequacy.

2.4 In most cases, the PRA does not expect SDDT firms to need to hold additional capital for credit risk under Pillar 2A. But in the following cases the PRA expects that additional capital for credit risk under Pillar 2A may be required:

- for new and growing banks as defined under supervisory statement (SS)3/21– Non - systemic UK banks: The PRA's approach to new and growing banks;⁴
- for SDDTs predominantly engaged in unsecured retail lending; or
- for 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.

The PRA's methodology for assessing Pillar 2A capital for credit risk

2.5 To inform the setting of Pillar 2A capital for credit risk, the PRA uses an SDDT's own assessment of its risk profile in its Internal Capital Adequacy Assessment Process (ICAAP) (in accordance with the expectations set out in paragraphs 2.11-2.16 of the draft SS– The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP) for Small Domestic Deposit Takers (SDDTs) ('draft SDDT ICAAP SS').⁵ The PRA exercises supervisory judgement to assess whether to set a Pillar 2A credit risk add-on for an SDDT. Where an SDDT meets the criteria in paragraph 2.4, but does not provide an assessment of credit risk in its ICAAP, 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.

³ Firms meeting SDDT criteria would mean that they do not have any approval to use the internal ratings-based (IRB) approach.

⁴ April 2021: <https://www.bankofengland.co.uk/prudential-regulation/publication/2021/april/new-and-growing-banks-ss>.

⁵ September 2024: www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2024/september/cp724app6.pdf

Reporting

2.6 While SDDTs are not required to submit regulatory returns in relation to Pillar 2A credit risks, SDDTs meeting the criteria set out in paragraph 2.4 are expected (as set out in paragraph 2.11 – 2.16 of the draft SDDT ICAAP SS) to detail their analysis in their ICAAP.

3 Operational risk

3.1 This chapter sets out the methodology the PRA uses to inform the setting of an SDDT's Pillar 2A capital requirement for operational risk.

Definition and scope of application

3.2 Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, and includes legal risk.

3.3 SDDTs' Pillar 1 capital requirements for operational risk are determined in accordance with the Operational Risk Part of the PRA Rulebook. The PRA considers that it continues to be important to assess operational risk as part of Pillar 2A to ensure any idiosyncratic risks that are not well captured in Pillar 1 are considered, as well as the relevance of the firm's past losses to their future operational risk. This ensures operational risk capital requirements are adequate given the risks SDDTs face whilst remaining flexible and risk sensitive. The PRA therefore assesses operational risk as part of its Pillar 2 review of SDDTs' capital adequacy.

Methodology for assessing Pillar 2A capital for operational risk

3.4 The PRA considers operational risk add-ons for all SDDTs. To set the Pillar 2A add-on for operational risk, the PRA reviews an SDDT's operational risk assessments in its ICAAP against a set of criteria and uses supervisory judgement to allocate it to one of three 'buckets', which relate capital requirements to an SDDT's operational risk. The PRA takes into consideration the SDDT's business model, exposure to operational risk, management of operational risk and suitability of mitigating actions in place, and any other factors the PRA judges relevant. These will be informed by the SDDT's analysis in its ICAAP, including scenario analysis and any historical losses and/or expected losses, as well as any insights gathered through engagement with the SDDT.

3.5 The PRA considers that bucket 1 is for SDDTs with simple business models, and/or that are not significantly exposed to operational risk, and/or that demonstrate effective management of operational risk. Bucket 2 is for SDDTs with more complex business models and/or some concerns on the exposure to and/or management of operational risk. Bucket 3 is for SDDTs with significantly complex business models and/or material concerns on the management of operational risk. The PRA may also consider bucket 3 for new SDDTs, as these firms are typically fast growing, and small firms, as these firms may be exposed to operational risk that is higher as a proportion of their assets.

3.6 Each bucket has a corresponding total operational risk capital requirement expressed as a share of the SDDT's total assets. The Pillar 2A add-on for operational risk is the requirement from the bucket minus the SDDT's Basel 3.1 operational risk Pillar 1 requirement. Once determined, the firm's Pillar 2A add-on will be converted into a percentage of risk-weighted assets (RWAs), such that it is adjusted proportionately with RWAs in between the firm's Capital Supervisory Review and Evaluation Process (C-SREP). If the operational risk Pillar 1 is higher than the requirement from the bucket, the SDDT would have

no Pillar 2A add-on for operational risk and would only be subject to a Pillar 1 operational risk requirement. The PRA also uses supervisory judgement to assess the Pillar 2A add-on and may vary the approach on a case-by-case basis including in being able to set an add-on above the bucket 3 level if judged to be necessary.

Table 1: Operational risk buckets informing Pillar 2A add-on

Bucket 1	Bucket 2	Bucket 3
0.3% of total assets	0.65% of total assets	1.25% of total assets

3.7 The PRA will keep these calibrations under review and adjust if there is a prudential case to do so in future.

Reporting

3.8 SDDTs are not required to submit regulatory returns in relation to Pillar 2A operational risk. Expectations for SDDTs in relation to including information in their ICAAP are included in draft SDDT ICAAP SS.

4 Credit concentration risk

4.1 This chapter sets out the methodology the PRA uses to inform the setting of an SDDT's Pillar 2A capital requirement for credit concentration risk.

Definition and scope of application

4.2 Credit concentration risk (CCoR) is the risk of losses arising as a result of concentrations of exposures due to imperfect diversification. This imperfect diversification can arise from the small size of a portfolio or a significant number of exposures to specific obligors (single-name concentration) or from imperfect diversification with respect to economic sectors or geographical regions. In the context of SDDTs, credit concentration risk can be material given their small size; however, SDDTs' geographical homogeneity – as the criteria to enter the regime require them to be domestically focussed – allows for simpler calculation of their geographical concentration risk.

Methodology for assessing Pillar 2A capital for credit concentration risk

4.3 For SDDTs, the PRA sets Pillar 2A CCoR capital add-ons based on their wholesale RWAs ('wholesale add-on') and retail RWAs other than SA residential mortgage portfolios ('retail add-on'). The wholesale RWA add-on is calibrated to include risks from geographic, sector and single-name concentration. The retail RWA add-on only covers geographic concentration risk, as sector and single-name concentration risks tend not to apply to retail exposures, given their nature.

4.4 The PRA wholesale add-on applies to all credit RWAs excluding residential mortgages, unsecured retail, short-term liquid exposures to financial institutions and exposures in default. The wholesale add-on is set at 3.5% of relevant RWAs. The PRA retail add-on applies to all remaining credit RWAs, excluding wholesale RWAs, short-term liquid exposures to financial institutions, exposures in default, and residential mortgages. The retail add-on is set at 1% of

relevant RWAs. The PRA will keep these calibrations under review and adjust if there is a prudential case to do so in future.

4.5 For the purposes of calculating the 3.5% CCoR wholesale add-on, wholesale credit RWAs will be calculated as the cell OF 02.00S – R0040C0010 minus the following six cells:

- OF 07.00S: retail exposures – R0010C0220,
- OF 07.00S: real estate exposures – R0330C0220,
- OF 07.00S: real estate exposures – R0351C0220,
- OF 07.00S: real estate exposures – R0352C0220,
- OF 07.00S: exposures to institutions – R0180C0220,
- OF 07.00S: exposures in default – R0010C0220.

4.6 For the purposes of calculating the 1% CCoR retail add-on, retail credit RWAs will be calculated as the sum of the following cells:

- OF 07.00S: retail exposures – R0010C0220,
- OF 07.00S: real estate exposures – R0351C0220,
- OF 07.00S: real estate exposures – R0352C0220.

4.7 In addition to the wholesale add-on set out above, the PRA reviews firms with particularly significant exposures in relation to single-name risk and sector concentration risk. The PRA reviews single-name concentration by considering the sum of an SDDT's large exposures, as defined in Rule 1.2(b) in the Large Exposures (CRR) Part of the PRA Rulebook,⁶ relative to its Tier 1 capital. The PRA reviews this measure and engages with SDDTs for which the sum of their large exposures is above 300% of their Tier 1 capital. This engagement will focus on better understanding the SDDT's approach to and management of single-name concentration risk, so that the PRA can form a view on whether the SDDT is sufficiently capitalised for this risk through the RWA-based CCoR add-on. The PRA expects to monitor this through the existing large exposure reporting within COREP as required by Article 394 Reporting Requirements in the PRA Rulebook.

4.8 For SDDTs with significant wholesale exposures, the PRA expects any sector concentration risks from these exposures to be reflected in the design of stress scenarios, as outlined in the draft SDDT ICAAP SS. As part of the C-SREP process, the PRA will engage with SDDTs to ensure they have sufficiently explored how their sector concentrations could crystallise in a severe and plausible stress.

4.9 The PRA maintains supervisory discretion to set an additional capital add-on if it judges an SDDT is not prudently monitoring or managing concentration risk. When setting the Pillar 2A credit concentration risk capital add-on, the PRA exercises judgement and may also consider a range of other factors, including an SDDT's ability to manage concentration risk;

⁶ Large Exposures (CRR) Part of the PRA Rulebook: <https://www.prarulebook.co.uk/prarules/large-exposures-crr>.

the SDDT's business model; and any other factors not adequately captured under the quantitative assessment.

Reporting

4.10 SDDTs are not required to submit regulatory returns in relation to credit concentration risk. Expectations for SDDTs in relation to including information in their ICAAP are included in the draft SDDT ICAAP SS.

5 Interest rate risk in the banking book

5.1 This chapter sets out the methodology the PRA uses to inform the setting of an SDDT's Pillar 2A capital requirement for interest rate risk in the non-trading book, commonly known as interest rate risk in the banking book (IRRBB).

Definition of scope of application

5.2 IRRBB is the risk of losses arising from changes in the interest rates associated with banking book items. These losses can arise from different sources:

- Duration risk arises when the re-pricing of banking products (assets and liabilities) is mismatched across time buckets. SDDTs generate these positions via the normal running of their banking book and manage the resultant risks through their internal management processes and hedging activities.
- Basis risk is generated by banking book items that re-price in relation to different reference rates. The most common and material basis risks seen within UK banks derive from products re-pricing against policy rates (eg Bank Rate) and market rates (eg SONIA). As part of the review of basis risk the PRA also considers asset swap spread risk, which typically arises when SDDTs hedge the duration risk associated with fixed rate securities using derivatives (typically interest rate swaps).
- Optionality risk arises from the discretion that a bank's customers and counterparties have in respect of their contractual relations with the bank in the form of financial instruments. Embedded options are diverse and firm-specific and include prepayment risk on fixed rate loans and deposits and switching risk on non-interest bearing current accounts. Optionality risk is considered separately when material.

5.3 SDDTs with less complex IRRBB exposures are subject to a standard approach, which is based on reviewing their own policy limits for duration risk. A proportionate approach is applied where an SDDT demonstrates some aspects of complexity with a detailed review undertaken of the policy limit-setting approach, the potential for any breaches and the ability of the SDDT to manage the associated risks.

5.4 The complexity of IRRBB varies across firms and the PRA expects SDDTs to monitor and adequately capitalise against the risks that they are exposed to. If an SDDT has more complex IRRBB exposures, the PRA may apply the comprehensive approach to IRRBB risk assessment, in which the PRA reviews duration risk, basis risk and, as necessary, optionality risk. This would be applied in line with the comprehensive approach for large or more complex firms in the 'Interest rate risk in the banking book' section of the PRA SoP – The PRA's methodologies for setting Pillar 2 capital.

Standard methodology for assessing Pillar 2A capital for IRRBB for SDDTs with less complex IRRBB exposures

5.5 The PRA reviews the internal policy limits used by an SDDT. The capital requirement for IRRBB is an SDDT's risk appetite for EV sensitivity (or EVE sensitivity where an SDDT does not calculate EV sensitivity) to parallel up and down shifts in interest rates across the whole yield curve. The size of the shift currently used by the PRA as a benchmark is 200 basis points. The capital requirement is subject to the PRA being comfortable with the way an SDDT measures sensitivity, including any behavioural assumptions being used, and that the SDDT has the risk management capabilities and processes in place to manage within its risk appetite.

Basis risk

5.6 Under the standard methodology for SDDTs with less complex IRRBB risk exposures, the PRA does not assess Pillar 2A for basis risk. Nevertheless, the PRA expects that an SDDT mitigates its basis risk by setting limits on:

- its exposure to basis risk for each type of basis risk mismatch; and
- the sensitivity of its net interest margin to basis risk.

Behavioural adjustments

5.7 The PRA may allow SDDTs, on a case-by-case basis, to allocate maturities based on behavioural assumptions.

Reporting

5.8 The PRA uses existing data reports, such as FSA017, and works with individual SDDTs to set out additional bespoke data requirements where needed, for the IRRBB assessment. The PRA may also ask SDDTs to submit internal management information relevant to IRRBB.

6 Pension obligation risk

6.1 This chapter sets the methodology the PRA uses to inform the setting of an SDDT's Pillar 2A capital requirement for pension obligation risk.

Definition and scope of application

6.2 Pension obligation risk is the risk:

- to an SDDT caused by its contractual or other liabilities to, or with respect to, a pension scheme (whether established for its employees or those of a related company or otherwise); and
- that an SDDT will make payments or other contributions to, or with respect to, a pension scheme because of a moral obligation or because the SDDT considers that it needs to do so for some other reason.

6.3 Pension obligation risk relates to defined benefit pension schemes and defined contribution schemes offering guaranteed returns that are not fully matched by underlying investments. Hybrid schemes are considered to be defined benefit pension schemes. Pension obligation risk includes the risk arising from overseas pension schemes.

6.4 A sponsoring firm is an SDDT with contractual or potential commitments to one or several defined benefit pension schemes covering its employees or the employees of another entity within the same group.

6.5 Pension obligation risk manifests itself in different forms. The PRA's focus is on the impact that changes in value of a pension scheme could have on Common Equity Tier 1 (CET1). The accounting deficit of an SDDT's pension scheme is reflected in CET1. Under Article 36(1)(e) of the Own Funds and Eligible Liabilities (CRR) Part of the PRA Rulebook, any surpluses are deducted. Firms are therefore exposed to pension obligation risk because a material increase in the pension scheme's deficit under adverse conditions will have a negative impact on their CET1.

6.6 An SDDT that does not deduct its pension scheme deficit from CET1 (eg because another company within the group recognises the deficit on its balance sheet) may still be exposed to indirect pension obligation risk, where the UK Pensions Regulator (TPR) has the power to require the SDDT to support the pension scheme, or where the failure of the company that recognises the deficit could destabilise the group, leading to the risk of contagion.

6.7 The PRA does not have a remit to protect members of defined benefit pension fund schemes against the failure of those plans. Nevertheless an SDDT must at all times comply with the overall financial adequacy rule. Accordingly, the PRA aims to ensure that SDDTs are adequately capitalised against their defined benefit pension obligations.

Methodology for assessing Pillar 2A capital for pension obligation risk

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

- the SDDT'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 SDDT's own assessment of the level of capital required.

6.9 The SDDT's own assessment and the PRA stress tests on the accounting basis can be reduced by offsets and management actions, and any pension scheme deficit deducted from CET1.

6.10 The PRA uses the results of two scenarios it prescribes to assess the adequacy of the SDDT's own assessment of the appropriate level of capital and to inform the setting of the Pillar 2A capital requirement for pension obligation risk. The higher of the two stress scenarios will form the starting point of the assessment.

6.11 The two scenarios are set out in **Table 2**.

Table 2 PRA pension obligation risk stress scenarios

Per cent	Scenario 1	Scenario 2
Fall in equity values	15	30
Fall in property values	10	20
Percentage reduction in long-term interest rates	10	15
Absolute increase in assumed inflation	0.5	0.75
Percentage change in credit spreads	-25	+25
Increase in liabilities due to a longevity stress	3	6

6.12 The PRA recognises that the assumptions underpinning the stress scenarios may not be appropriate for the risk profile of all pension schemes. Where the PRA believes that the risk profile of an SDDT's pension scheme deviates significantly from the assumptions underlying the published scenarios, it will use other models to inform the appropriate level of Pillar 2A pension obligation risk capital to compare against the SDDT's own assessment.

6.13 For the purposes of the stress scenarios, the PRA expects the valuation measure of liabilities to be the same as that used for IFRS reporting. SDDTs' approaches to setting the valuation assumptions should be stable over time and any changes to the approach should be justified in the ICAAP. The PRA will review the robustness of the valuation assumptions and may adjust the surplus or deficit in the capital requirements calculations where the assumptions are found to be out of line with other firms, or where an alternative set of assumptions better satisfies the capital adequacy rules.

6.14 The stress scenarios have been designed to produce an appropriate level of capital for a typical pension scheme. From time to time, it may be necessary to update the scenarios to ensure that they continue to remain appropriate. This may be done, for instance, where significant movements in market conditions mean that the scenarios produce inappropriate levels of capital or where the average risk profile of the pension schemes sponsored by PRA-regulated SDDTs deviates from the risk profile the PRA has assumed when calibrating the stress scenarios.

6.15 The scenarios described in Table 2 are distinct from the multi-year firm-wide scenarios the PRA expects SDDTs to develop in their ICAAP in accordance with the general stress test and scenario analysis.⁷

6.16 The PRA reviews the scenarios on an annual basis, but only expects to make changes to them every few years. Any changes will be consulted on before being implemented.

Offsets and management actions

6.17 The SDDT's own assessment of the appropriate level of capital and the results of the PRA stress scenarios may be reduced by eligible offsets and management actions recognised by the PRA. Offsets are reductions in an SDDT's Pillar 2A capital requirement to reflect factors present at the ICAAP effective date which would reduce the impact of a stress on the SDDT. Management actions are steps the SDDT could, and would, take when a stress occurs in order to reduce its impact.

6.18 To be accepted by the PRA, offsets and management actions in relation to the PRA stress scenarios should comply with the following eligibility criteria:

- financial performance — the efficacy of offsets and management actions should not depend on assumptions as to the future financial performance of the SDDT, either before or after a stress;
- independence from the decisions and actions of third parties — the efficacy of offsets and management actions should not depend on assumptions as to the future agreement or behaviour of third parties, either before or after a stress; and
- immediacy — recognised offsets should reflect a risk mitigation benefit that is already effective when the offset is taken. Management actions should be capable of taking effect quickly enough to mitigate the stress to which they are the proposed response.

6.19 The PRA expects SDDTs to explain any offsets or management actions they propose. Where practical, management actions will be formulated after discussion with pension scheme trustees. The PRA will apply the eligibility criteria in a strict manner on a case-by-case basis. Offsets and management actions that do not meet the eligibility criteria will not be accepted.

Reporting

6.20 All SDDTs with defined benefit pension schemes are required to report the data contained in the pension risk data item in accordance with Reporting Pillar 2, 2.6. SDDTs are required to submit the data with their ICAAP submissions.

7 Market risk

7.1 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.

⁷ Rule 12.1 in Internal Capital Adequacy Assessment Part of the PRA Rulebook: <https://www.prarulebook.co.uk/prarules/internal-capital-adequacy-assessment>.

7.2 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, the PRA may apply Pillar 2A add-ons using other methodologies, including those set out in the PRA SoP – The PRA’s methodologies for setting Pillar 2 capital, informed by the relevant information set out in the ICAAP in line with SS31/15 – The Internal Capital Adequacy Assessment Process (ICAAP) and Supervisory and Evaluation Process (SREP).⁸

8 Counterparty credit risk

8.1 Counterparty credit risk (CCR) is the risk of losses arising from the default of the counterparty to derivatives, margin lending, securities lending, repurchase and reverse repurchase or long settlement transactions before final settlement of the transaction’s cash flows and where the exposure at default is crucially dependent on market factors.

8.2 The PRA considers that applying the Pillar 1 CCR framework, including generally complicated calculations, is not proportionate given the low level of CCRs typically exhibited by SDDTs. However, the materiality of CCR varies across firms, and the PRA expects SDDTs to monitor and adequately capitalise against the risks that they are exposed to. If an SDDT does not manage its CCR prudently, the PRA may expect the firm to hold additional capital under Pillar 2. This could take the form of a risk management and governance scalar, as set out in Section II of this SoP, or a Pillar 2A add-on in line with the ‘Counterparty credit risk’ section of the PRA SoP – The PRA’s methodologies for setting Pillar 2 capital.

9 Group Risk

9.1 Group risk, as defined in the PRA Rulebook,⁹ 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.

9.2 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, the PRA may apply Pillar 2A add-ons using other methodologies, including those set out in the PRA SoP – The PRA’s methodologies for setting Pillar 2 capital, informed by the relevant information set out in the ICAAP in line with SS31/15.

10 Level of application

10.1 The PRA will normally set a Pillar 2A capital requirement for an SDDT on an individual basis. The PRA will additionally set Pillar 2A capital requirements for SDDT consolidation entities which must comply with the overall financial adequacy rule in ICAA 2.1 on a consolidated basis.

10.2 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

⁸ May 2023: <https://www.bankofengland.co.uk/prudential-regulation/publication/2013/the-internal-capital-adequacy-assessment-process-and-supervisory-review-ss>.

⁹ Internal Capital Adequacy Assessment 1.2.

Pillar 2A add-ons according to the individual SDDT's risk profile. Alternatively, the PRA may opt to set Pillar 2A capital requirements on an individual basis based on a top-down assessment of the group's TCR and then calibrate the TCR of its subsidiaries to correspond to a share of the group's TCR. This approach might be suitable if the firm can demonstrate that capital has been effectively allocated among its subsidiaries, and that the members of the group are strongly incentivised to support each other, and there are no impediments to the transfer of capital within the group. Where an SDDT has a very similar risk profile to its UK 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 Pillar 2A capital requirement to the individual total RWAs of the firm.

Draft for consultation

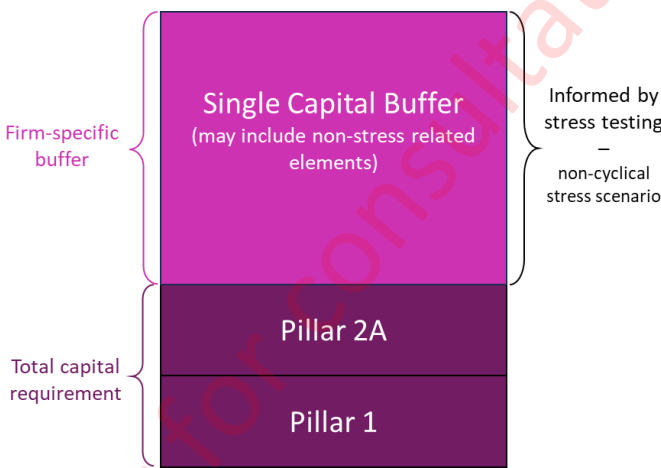
Section II: Pillar 2B methodologies

11 The Single Capital Buffer

Purpose and objective of the Single Capital Buffer

11.1 The Single Capital Buffer (SCB) is a firm-specific buffer that SDDTs should maintain in addition to their total capital requirement (TCR).¹⁰ The SCB is designed to absorb losses that may arise under a severe but plausible stress scenario, with the aim of ensuring SDDTs continue to meet their TCR through a stress. The SCB and the TCR make up the PRA’s capital framework for SDDTs as illustrated by the capital stack in **Figure 1**.

Figure 1. The capital stack for SDDTs



11.2 SDDTs should maintain capital to meet their TCR (Pillar 1 plus Pillar 2A capital requirements) at all times but are expected and encouraged to use their SCB to manage a stress. Therefore, the use of the whole or part of the SCB would not itself be considered a breach of capital requirements or threshold conditions (TC).

11.3 The SCB is designed as a non-cyclical buffer. The SCB for each SDDT is expected to remain relatively stable over economic and financial cycles if the SDDT’s balance sheet risks and composition do not change materially. However, the SCB will vary on a firm-by-firm basis, in accordance with each SDDT’s risk profile and balance sheet.

11.4 The SCB is set using three assessments:

- (a) the ‘stress impact’: an assessment of the amount of capital SDDTs should maintain to withstand a severe but plausible stress scenario informed by firm-run stress testing based on a non-cyclical scenario;¹¹

¹⁰ Total capital requirements are the sum of Pillar 1 capital requirements plus Pillar 2A capital requirements.

¹¹ New and growing banks under the SDDT regime are subject to an alternative approach to setting the SCB which is set out in SS3/21.

- (b) the 'risk management and governance assessment': an assessment of whether an SDDT has significant risk management and governance (RMG) weaknesses; and
- (c) 'supervisory judgement': an assessment of any other relevant information to inform adjustments to the SCB in order to protect the safety and soundness of SDDTs.

11.5 All components of the SCB including the RMG scalar should be met by CET1 capital.

Setting the Single Capital Buffer

11.6 The frequency of assessment of the SCB is aligned to an SDDT's SREP cycle and is ordinarily carried out every two to four years. The PRA may reassess the SCB more frequently when an SDDT's circumstances change. For example, a change in business model or strategy, material changes in a firm's risk profile, or when RMG weaknesses are either identified or resolved.

A. The stress impact

11.7 The SCB component relating to the stress impact aims to ensure that the SCB captures firm-specific exposures to common and idiosyncratic risks. Accordingly, the stress test impact relies on firm-run stress testing results.

11.8 The stress impact is set with reference to each SDDT's risk-weighted CET1 hurdle rate, which is the level of CET1 capital firms are expected to maintain in a severe but plausible stress. For SDDTs, the hurdle rate is equal to the TCR (Pillar 1 and Pillar 2A) applicable to all tiers of capital.

11.9 The PRA carries out an assessment of SDDT's ICAAP stress testing results as part of the SREP.¹² The assessment considers the credibility and reasonableness of each SDDT's projected stress results and the underlying assumptions on which the stress projections are built. The assessment focusses on the areas where the stress scenario adversely impacts the SDDT's capital positions (ie reducing capital resources and/or increasing capital requirements), the nature and severity of the scenario on which the stress results are based, and the reasonableness of the actions the SDDTs proposes to mitigate the impact of the stress.

11.10 Assumptions underlying the stress projections, and the choice of scenario and stress projections are analysed and compared against the PRA's own internal models, peer benchmarks and information submitted in each SDDT's ICAAPs. Where the PRA has concerns around the credibility of the SDDT's stress testing results, adjustments will be made.

11.11 The SCB will be set at a level no lower than 3.5% of each SDDT's RWAs, before considering the RMG assessment, even where firm-specific stress testing results¹³ suggest a buffer lower than 3.5% of the SDDT's RWAs. This level would support the resilience of SDDTs, on average across SDDTs and through-the-cycle. Stress testing results of SDDTs

¹² Stress testing and scenario analysis requirements are set out in Chapter 12 of the Internal Capital Adequacy Assessment rules and in Chapter 3 of the draft SDDT ICAAP SS.

¹³ Or 6 months operating expenses for new and growing banks subject to the buffer calculation set out in SS3/21.

more exposed to common and idiosyncratic risks are expected to produce numbers higher than 3.5% of RWAs.

Stress scenario

11.12 The PRA publishes annually two non-cyclical scenarios to serve as a guide for SDDTs when designing their own scenarios in the context of the ICAAP stress tests.¹⁴ These scenarios provide a benchmark for the severity and nature of stress scenarios that the PRA considers appropriate for SDDTs.¹⁵ The PRA encourages SDDTs to consider the type, characteristics, and severity of stress that their business model is vulnerable to.

11.13 These stress testing scenarios are non-cyclical with a relatively constant impact across ICAAP/SREP cycles, to ensure that the size of the SCB for SDDTs is insensitive to the timing of their SREP and to the point in the economic cycle when SCB setting occurs. The scenarios are set such that as the economy moves through the economic and financial cycles, the generated stress impact remains, on average, at a 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 change in response to material changes in the structure (ie not related to the economic or financial cycle) of the economy or financial system that are relevant for SDDTs.

Capital resources in stress testing

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

Capital requirements in stress testing

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

11.16 To reflect the evolution of the Pillar 2A requirements in a stress, the PRA scales each of the Pillar 2A risk components with a suitable metric considered to be an underlying driver (or closely related to an underlying driver) of the particular risk type. The PRA will consider the best scaling base to apply while maintaining the simplicity of the calculation.

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

¹⁴ <https://www.bankofengland.co.uk/stress-testing>.

¹⁵ The PRA may also ask SDDTs to run additional sensitivity analyses, the purpose of which will be to explore the impact on portfolios and/or regions, which are not covered in the PRA's published scenarios or the SDDT's idiosyncratic scenarios. The results of these sensitivity tests may be used to adjust the assessment of the stress impact.

Table 3 – Pillar 2A scaling bases relevant for SDDTs

Risk type	Scaling base
Operational risk ¹⁶	Leverage exposure measure
Pension risk	No scaling – remains a fixed add-on
Interest rate risk in the banking book (IRRBB)	Leverage exposure measure
Credit concentration risk	Pillar 1 credit RWAs
Credit risk	Pillar 1 credit RWAs
Other risks	As appropriate

Management actions

11.18 The PRA recognises management actions that an SDDT could and would realistically take to mitigate the impact of the stress scenario. Guidance on management actions is provided in the draft SDDT ICAAP SS.

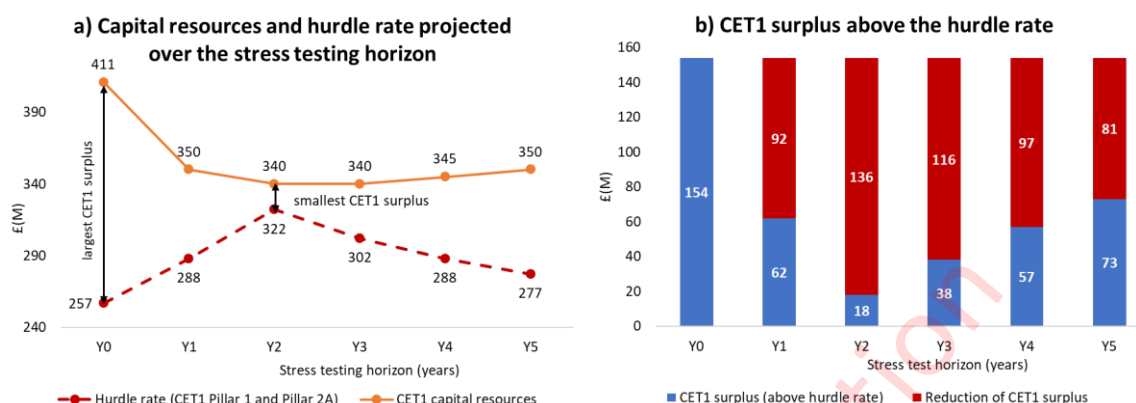
11.19 When assessing the credibility of the management actions, the PRA will consider the following:

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

11.20 The credibility of capital-related management actions such as the issuance, redemption, and amortisation of AT1 and Tier 2 capital instruments will be considered against the planned capital exercises in a SDDT's baseline projections. The feasibility, timing and pricing of the issuances and redemptions in the stress scenario will be considered.

¹⁶ Including information technology risk.

Stylised example

Figure 2. Simplified illustration of the stress impact assessment

11.21 **Figure 2** presents a stylised example to illustrate the key elements which the PRA considers during the stress impact assessment.¹⁷ **Figure 2.a** shows the projected CET1 capital resources and hurdle rate (CET1 Pillar 1 plus Pillar 2A) over a 5-year stress testing horizon, where Y0 indicates the starting point. CET1 capital resources (orange line) reduce in a stress due to lower income and profitability and higher losses. The hurdle rate (red dashed line), instead, increases as a result of riskier balance sheet in a deteriorating economic environment. **Figure 2.a** also shows the CET1 surplus, namely the difference between the CET1 capital resources and the hurdle rate at each year of the stress testing horizon. Blue bars of **Figure 2.b** show the CET1 capital surplus, which is maximum in period Y0 (£154M = £411M - £257M) and minimum in period Y2 (£18M = £340M - £322M).

11.22 The total amount of CET1 capital that the SDDT is expected to hold is given by the difference between the maximum CET1 capital surplus and the minimum CET1 capital surplus. The red bars in **Figure 2.b** shows the reduction of CET1 surplus compared to the maximum at period Y0. In this example, the capital that the SDDT is expected to hold is equal to £136M = £154M - £18M, which informs the stress test impact.

11.23 The SCB will be set at a level no lower than 3.5% of each SDDT's RWAs, before considering the RMG assessment. This means that if the SDDT considered in the example has RWAs equal to £4533M, hence the stress assessment predicts a SCB in terms of the SDDT's RWAs of 3% = $(£136M/£4533M) \times 100$, the SCB would be set at 3.5%. In the other case in which the SDDT's RWAs are equal to £3400M, hence the stress impact assessment predicts a SCB in terms of the SDDT's RWAs equal to 4% = $(£136M/£3400M) \times 100$, the SCB would be set at 4%. In both cases, the Risk Management and Governance assessment and other supervisory judgments can imply changes to the final value of the SCB (which in any case cannot be set a level lower than 3.5%).

¹⁷ This is a stylised example to show the mechanics of the stress impact assessment. It does not represent all considerations taken into account for the assessment. The illustrative example assumes the SDDT does not breach the hurdle rate and has excess CET1 throughout the stress. The case of a projected CET1 shortfall is likely to increase the buffer calculation.

11.24 The stress testing scenarios are non-cyclical with a relatively constant impact across different ICAAP/SREP exercises. This means that the stress impact assessment is expected to generate broadly the same results in two different ICAAP/SREP exercises.

B. The risk management and governance assessment (RMG)

11.25 Where the PRA assesses a SDDT's RMG to be significantly weak, it may also set the 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 TCR. The scalar could be up to 40% of the total CET1 TCR.

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

11.27 If an RMG scalar is included in the SCB, RMG weaknesses identified in specific risk categories would not ordinarily be reflected in Pillar 2A capital requirements for those categories.¹⁸ Once the identified weaknesses have been remedied, the scalar should be removed. If new weaknesses emerge that are not adequately addressed by the scalar, or if previous remedial action taken by the SDDT firm has led to its removal, a new scalar may be applied.

11.28 The PRA aims to ensure consistency across SDDTs when making the recommendation on the RMG scalar.

C. Overall supervisory judgement

11.29 Supervisory judgement may be applied at all levels of the assessment process. A number of specific areas are outlined below. The PRA may use any appropriate information to inform adjustments to an SDDT's SCB.

Impact of projections under the base case

11.30 SDDTs are expected to be able to meet their SCB under the base case. Where a SDDT's CET1 capital falls short of meeting the SCB in the base case, the PRA's response will depend on the situation, but will most likely include a request for a revised capital plan to improve its stress resilience.

Post-balance sheet adjustments

11.31 The SCB calculation is dependent on each SDDT's balance sheet used to complete the ICAAP. At the time the SCB is set, the SDDT's balance sheet may have materially changed, eg through disposals and/or acquisitions. Where this has occurred, adjustments will be made ensuring the SCB remains consistent with the SDDT's balance sheet risk.

Weaknesses in stress testing processes and data quality

11.32 Supervisors consider the adequacy of an SDDT's stress testing process, the quality of its data submissions and the effectiveness of its model risk management practices. Where shortcomings and deficiencies are identified, the PRA may apply adjustments to specific

¹⁸ An exception might be if the risk were only partially addressed by the imposition of a scalar.

stress results or set a higher SCB to gain more comfort in the SDDT's stress results. Enhanced supervision may also be considered in instances of serious or persistent failings.

Other factors

11.33 The PRA expects SDDTs to hold a larger buffer or strengthen their capital position where potentially significant risks are not captured fully as part of the stress test.

Level of application

11.34 The PRA applies the SCB at each level of consolidation which applies to an SDDT or SDDT consolidation entity. Where the SDDT is not part of a group with an SDDT consolidation entity, the PRA will set the SCB on an individual basis; and where the SDDT is part of a group with an SDDT consolidation entity, the PRA will set the SCB both on an individual basis and on a consolidated basis. 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.

11.35 When setting the SCB on an individual basis, the PRA's standard approach is to undertake a full assessment on the individual basis.

11.36 Where a buffer¹⁹ for an entity established outside the UK exceeds that entity's share²⁰ of the buffer applicable at the consolidated group level to cover the same risk, the difference will generally be reflected in the setting of the consolidated group's SCB to reflect the associated group risk at the consolidated group level. The PRA would generally not reflect such a difference in the consolidated group SCB where the underlying risk of the credit institution established outside the United Kingdom is otherwise mitigated in the consolidated group requirements.

Application of the Single Capital Buffer for subsidiaries of UK consolidation groups

11.37 Where the SDDT is part of a UK group with an SDDT consolidation entity (ie 'an SDDT-subsiary'), the PRA's approach to setting the SCB on an individual basis depends upon: the transferability of group resources; the nature and extent of integration of the SDDT-subsiary; the likelihood of group support; and the significance of the entity and the risk profile of its business relative to the group. In all cases, whichever method the PRA uses to determine the SCB for a subsidiary, the PRA will set the individual SCB at a level no lower than 3.5%.²¹

11.38 The PRA's framework for applying the SCB to SDDT-subsiaries takes the group-level assessment as a starting point. The PRA may set the SCB for a SDDT-subsiary such that, when aggregated with the TCR, the total capital it is expected to hold is the same as the internal capital the SDDT-subsiary determines in its internal capital assessment to be sufficient. Internal capital must be sufficient to cover all the risks to which the SDDT-

¹⁹ In this context, buffer refers to capital that overseas authorities expect firms to hold in addition to minimum capital, and which is intended to be able to be drawn down in periods of stress.

²⁰ An entity's share of a particular consolidated group buffer can be determined by multiplying that consolidated group buffer by the proportion of the consolidated group's Pillar 1 RWAs that are attributable to that entity. The consolidated group's RWAs that are attributable to an entity is calculated as the entity's Pillar 1 RWAs, calculated on the same basis as the group RWAs, minus the risk-weighted exposures of that entity to other group entities.

²¹ New and growing banks under the SDDT regime are subject to an alternative approach to setting the SCB which is set out in 11.48.

subsidiary 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:

- on a UK consolidated basis, the SCB and TCR is the same as the internal capital the group considers to be adequate (eg when the SCB is set at 3.5% 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.

11.39 The PRA may also calibrate the SCB on an individual basis in this way where these conditions are not met but the SDDT-subsiary is not considered to be material to its consolidation 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.

11.40 Where an SDDT-subsiary has a very similar risk profile to its consolidation 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 SDDT-subsiary), the PRA may decide to set the SCB on an individual basis by reference to the UK consolidated SCB calculation.

11.41 The PRA will set the SCB according to a comprehensive individual assessment if none of the above approaches is applicable. The PRA may also set the SCB 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;
- 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.

The use of the Single Capital Buffer

11.42 SDDTs are expected and encouraged to use their SCB to manage a stress. The use of the SCB is not itself a breach of capital requirements or threshold conditions. The PRA does not expect or require SDDTs to finance themselves with more capital than the total of their regulatory requirements and buffers. However, SDDTs should not use the SCB in the normal course of business or enter into it as part of its base business plan.

11.43 In a scenario where an SDDT has identified the need to draw down on its buffer, and in line with Fundamental Rule 7,²² the SDDT must notify the PRA as early as possible. At a minimum, the buffer usage notification should include:

- (a) What adverse circumstances are likely to lead the SDDT to draw down its buffer;
- (b) How the buffer will be used in line with the SDDT's capital planning projections; and
- (c) A capital restoration plan setting out the identified actions and corresponding timeframe to restore the SCB.

11.44 An SDDT which does not meet its SCB can expect enhanced supervisory scrutiny and should prepare a capital restoration plan. If the PRA is satisfied with the rationale presented in the plan, the PRA will be content for the firm to rebuild its SCB over a reasonable period of time. In exercising its judgement on what constitutes a reasonable time to rebuild the SCB drawn down in stress, the PRA will take into account the amount of the SCB that has been used and the expected duration and drivers of the stress (whether firm specific or systemic). It will consider any firm-specific drivers of the use of the SCB, in the context of current and forecast 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.

11.45 SDDTs are not subject to automatic constraints on capital distributions when they use the SCB and the notification by an SDDT about its intention to draw down its SCB does not automatically trigger the use by the PRA of any of the supervisory tools at its disposal. Rather, a tool (or multiple tools) is selected on a case-by-case basis. More detail on the PRA's response to SDDTs using the SCB, including a set of scenarios and case studies illustrating the Supervisory Approach to Single Capital Buffer Usage, can be found in the Annex of this SoP.

Reporting

11.46 The scope and intensity of the PRA's assessment is proportionate to the nature, scale, size, and complexity of the SDDTs and is reflected in the granularity of the stress test data that SDDTs are required to submit.

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

²² 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.

New and growing banks under the SDDT regime

11.48 The SCB for new and growing banks²³ under the SDDT regime is not set using firms' stress testing results but as the buffer needed to cover six months of projected operating expenses.²⁴ As for all other SDDTs, however, it is set at a level no lower than 3.5% of each firm's RWAs at the point of the C-SREP. The PRA's capital expectations for new and growing banks under the SDDT regime are set out in the SS3/21.

Draft for consultation

²³ Defined as SDDTs which have been operating for five years or less since being authorised without restrictions and yet to achieve a profit over a full year of trading.

²⁴ Operating expenses are defined under SS3/21.

Annex - Supervisory Approach to Single Capital Buffer Usage

Introduction

The aim of this annex is to provide transparency on the supervisory activities that can occur following a notification of buffer usage, brought to life by hypothetical case studies.

This annex should be read in conjunction with:

- The PRA's approach to banking supervision;²⁵
- Section II of this statement of policy (SoP);
- Draft SS – The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP) for Small Domestic Deposit Takers (SDDTs).²⁶

Background: Expectations around Buffer Usage and Supervision of SDDTs

SDDTs are expected and encouraged to use their capital buffers in times of stress.

The PRA does not expect firms to finance themselves with more capital than the total of their regulatory requirements and buffers. Use of the single capital buffer is not itself a breach of capital requirements or TCs, and SDDTs are expected and encouraged to use their capital buffers to manage a stress.

The PRA expects SDDTs to avoid using the SCB during the usual course of business. It is the responsibility of the Board and management to ensure that the respective SDDT has sufficient capital to manage a future stress. This is markedly separate to the capital held to meet business plans and growth targets.²⁷ The PRA's reaction to a SDDT's buffer notification is not formulaic. Rather, it is centred around supervisory judgement, informed by prior engagement and supervisory activities.

The PRA's Approach to banking supervision communicates how the PRA approaches the supervision of deposit-takers, including SDDTs. During each Periodic Summary Meeting (PSM) cycle, the Supervision Team of an SDDT will engage with the firm through continued dialogue, risk assessment and supervisory activities. The supervisory activity during each cycle supports the early identification of risks to the firm's viability and will inform the Supervision Team's judgement on the firm's proximity to failure. The judgement around the proximity to failure will inform the level of supervision, and type of supervisory activities, the SDDT will be subject to.

Each scenario in which a SDDT draws down its SCB is firm-specific. A range of factors over varying time periods will contribute to the need for a SDDT to use its SCB. All such factors will be considered by the Supervision Team to determine their subsequent reaction and potential use of supervisory tools. Such factors include, but are not limited to:

²⁵ July 2023: <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/approach/banking-approach-2023.pdf>

²⁶ September 2024: <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2024/september/cp724app6.pdf>

²⁷ See Chapter 4 of SS3/21.

- Drivers and context of the stress (eg whether it is firm-specific or systemic);
- How far the firm has run/expects to run into its SCB (ie proximity to breaching its Total Capital Requirement (TCR));
- Expected duration of the stress; and
- Macroeconomic and financial conditions.

To allow for an informed supervisory reaction to buffer usage, the PRA refers SDDTs to the PRA's Fundamental Rule 7 that a firm must deal with its regulators in an open and co-operative way, taking the initiative to raise issues of possible concern at an early stage. This is true both during and outside of a stress period.

Scenarios and Case Studies

Each individual case of buffer draw down is firm-specific and caused by a range of factors. Notification of buffer usage is not necessarily a trigger for the PRA to alter its strategy and/or use a set suite of supervisory tools.

This Annex focuses on idiosyncratic, individual firm usage of SCB. The case studies below are all hypothetical examples of idiosyncratic stresses. It is recognised that the PRA could respond differently to a system-wide stress that resulted in buffer draw down of a significant proportion of the SDDTs population. For example, the PRA used discretion to allow firms to recover buffers over a reasonable time period during the Covid-19 stress.²⁸

To enhance clarity and provide transparency to SDDTs, this publication groups capital buffer usage into three scenarios. The scenarios are in ascending order of severity. It is possible that a firm could fall into the bucket of one of the less severe scenarios and over some time, move to a more severe scenario or vice versa. The scenarios are illustrated by hypothetical case studies which include examples of supervisory activities and tools that could be used prior to, and in response to, notification of the buffer draw down. Note, the following case studies are purely illustrative and an SDDT experiencing a similar scenario will not necessarily be subject to the same supervisory tools and activities.

Scenario 1: High probability of restoring capital

In scenario 1 there is a high possibility that the firm restores its capital position given that it uses a relatively low proportion of the buffer, resulting in buffer usage occurring only over the short term. The supervision team has reached this judgement through prior supervisory activities and consideration of other factors and is comfortable with the firm using its buffer during the stress. Case studies A & B below explore hypothetical examples of buffer usage that could fall under scenario 1.

Case Study A

Firm A operates a credible business model. Unexpectedly, Firm A experienced an operational risk event. Remediation was required immediately, but expenditure caused the

²⁸ See Q&A on the use of Liquidity and Capital Buffers, available at: <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/publication/2020/qanda-on-the-use-of-liquidity-and-capital-buffers.pdf>

firm to draw down its capital buffer. Firm A immediately notified the PRA of its intention to use its buffer during the stress and provided a capital restoration plan. The Supervision Team assessed the plan as credible, noting that the firm's low expected capital buffer usage created little risk of the firm breaching its TCR in the short term.

Over a short period, Firm A successfully restored its capital position above its buffer. The Supervision Team considered whether further Operational Resilience work is required over the next PSM cycle to ensure that the risks are understood and adequately mitigated.

Case Study B

Firm B is a relatively new entity that had a credible business plan upon authorisation. However, challenging market conditions made it difficult for the firm to become profitable within the forecasted period. Through regular supervisory engagement, the Supervision Team were aware of the firm's reliance on regular capital injections. However, a delay in investment resulted in Firm B drawing down its buffer.

The firm notified the PRA, setting out the rationale and capital restoration plan. Through constructive dialogue over the preceding months, the Supervision Team were already aware of the risk around delays to the capital injection and had sight of the mitigating actions identified if the plan was not successful. The Supervision Team judged the capital restoration plan to be credible and expected the capital injection to be forthcoming following the firm's discussions with potential investors.

Firm B continued with the capital raise and executed it a month later than originally planned, which restored its capital position to above the buffer. Following this, the Supervision Team adjusted the supervisory strategy to increase focus on the viability and sustainability of Firm B's business model.

Scenario 2: Medium probability of restoring capital

In Scenario 2, there is a medium probability that the firm restores its capital position. Here, either the firm runs relatively deep into its buffer or buffer usage is over a prolonged period. Case Study C below articulates this.

Case Study C

Firm C is experiencing significant business model challenges. The firm had forecast to draw down its buffer, and expected this buffer usage to persist for six months. Firm C forecasted a material capital buffer over its TCR and notified the PRA sufficiently in advance of drawing down on the buffer.

The Supervision Team viewed there to be a reasonable probability that the firm could restore its capital position out of its buffer. However, given the expected use of its buffer, Firm C recognised that it would not be appropriate to continue with the planned distribution of capital to shareholders and the management team.

This view was informed by supervisory activities conducted over the prior PSM cycle in which management and governance weaknesses were identified, exacerbated by the ongoing concerns regarding the viability and sustainability of the business model. These concerns resulted in a management and governance Section 166 being commissioned by the PRA.

Around the time of the buffer notification, Firm C was scoping the Section 166 review and the Supervision Team requested the capital restoration plan to also be assessed as part of the

report. To gain additional assurance, the Supervision Team engaged PRA to assess the executability of Firm C's latest Recovery Plan.

Whilst the Section 166 was underway, the PRA met with Firm C's Chair to discuss the business model challenges and management and governance weaknesses. The Chair proactively called a Board meeting to discuss options around altering the business strategy to preserve capital.

The Section 166 report produced actions which Firm C executed in a timely manner. The improved management team and governance framework, alongside the change in business strategy, aided the execution of the capital restoration plan within the expected timeframes.

Scenario 3: Low probability of restoring capital

Scenario 3 captures prolonged and frequent use of a large portion of the buffer. This goes against the PRA's expectations that the buffer should not be used as business-as-usual. In Scenario 3, the Supervision Team judged there to be a low probability of restoring capital. Case Study D and Case Study E set out hypothetical examples of firms that lie within Scenario 3.

Case Study D

Firm D had a high capital burn rate, which was driven by a notably large cost base. Adverse macroeconomic conditions highlighted weaknesses in the business and the firm struggled to maintain a stable capital position for several years. As a result, Firm D experienced a prolonged period of drawing down its buffer and relied upon frequent capital injections to remain just above its buffer.

Given ongoing concerns around the viability of Firm D, recent supervisory activity involved a Section 166 which assessed the executability of both its Recovery Plan and Solvent Exit Plan.

The latest buffer notification from the firm included a capital restoration plan which centred around raising capital from investors. However, the Supervision Team was informed by the firm's management team that existing shareholders were becoming reluctant to inject further capital. In addition, the Section 166 review found material gaps in the executability of both the Recovery Plan and Solvent Exit Plan.

Management and the Board recognised this and put in place restrictions on taking new deposits above the FSCS limit. Firm D's strategy was also altered to reduce lending and preserve capital. These actions increased Firm D's proximity to TCR to some extent.

However, the Supervision Team, aware of the firm's challenging history and prevailing macroeconomic headwinds, judged the curtailing of lending and deposits to be insufficient. The Supervision Team met with the Board and management team to discuss options. A decision was made by the Board to pursue the sale of some assets and liabilities to shrink its balance sheet size and simplify its business model. To mitigate the risks of failing to execute the sale of assets and liabilities, the Board put in place triggers for activation of the Solvent Exit Plan which was supported by the Supervision Team.

The sale of assets and liabilities was successful and increased the firm's proximity to TCR by enough to focus on simplifying the business model. The actions taken by management and the Board provided sufficient confidence to existing shareholders to support the firm, which restored its capital position above its buffer.

Case Study E

Firm E ran a high-risk business model. The firm struggled to maintain a stable capital position for several years which resulted in the firm frequently seeking to raise capital from the market to avoid using buffers during the usual course of business.

Poor performance of Firm E's lending book prompted the Supervision Team to focus activities on the firm's risk management and control framework, with a credit risk review revealing material weaknesses in the control environment. Other supervisory activities have reflected this prolonged period of instability, including:

- Holding frequent meetings with members of the executive team;
- Requiring the firm to submit monthly updated capital forecasts;
- Section 166 on the Recovery Plan and Solvent Exit Plan.

During the most recent PSM cycle, the Supervision Team observed improvements in governance and controls, which resulted in the decision to remove the capital scalar that had previously been placed on Firm E. However, the firm continued to be loss making, which was exacerbated by a deteriorating macroeconomic environment. Firm E eventually submitted another buffer breach notification which included a capital restoration plan centred around a further capital raise.

Considering the context of Firm E's ongoing struggles, the PRA did not have confidence in the latest capital restoration plan. Given the firm's high monthly expenditures and close proximity to TCR, the PRA encouraged the firm to consider ceasing new lending. Firm E agreed to this and submitted an application to implement a Voluntary Requirement (VREQ). The PRA accepted this application on the basis that this would preserve capital until a new investor is found.

However, Firm E ran deeper into its buffer without any success in attracting new investors and raising new capital. The firm remained loss making and identified that it would breach its Solvent Exit capital trigger in 3 months and TCR in 6 months. Through continued dialogue with Firm E, the Supervision Team reiterated the responsibilities of the firm's SMF holders.

Following a stalling in the firm's negotiations with a final potential investor, and the lack of another credible recovery option, the Board took the decision to execute a Solvent Exit. This is completed successfully, with Firm E repaying all deposits in the following year and remaining above TCR throughout. At the end of the solvent exit, Firm E applied for a Voluntary Variation of Permissions (VVOP) to remove its Part 4A permissions.

The case studies above included examples of types of supervisory activities and engagement prior to, and during, SCB usage. For transparency, Table A below identifies these activities which have been extracted from the hypothetical case studies. Table A is a non-exhaustive list and there are other supervisory activities and tools that could be considered for use, depending on the specific circumstances of buffer usage. There are no automatic triggers for the PRA to take a particular course of action, rather, these are taken on a case-by-case basis. This is dependent upon which activities are most appropriate to the circumstances of the firm, considering information obtained from prior supervisory engagement and other circumstantial factors.

Table A: Supervisory activities extracted from case studies

<p>Notification Requirements</p> <p>Consistent with Fundamental Rule 7, a firm should notify the PRA as early as possible where it has identified that it would need to use its buffer.</p>
<p>Supervisory Engagement</p> <p>The level of supervisory engagement will depend upon the specific case for drawing down the buffer. It is possible that supervisory engagement may increase, with more frequent meetings.</p>
<p>Capital Restoration Plan</p> <p>At the point where a firm identifies the need to draw down its buffer, the firm should prepare a capital restoration plan that details how it will seek to restore its capital position to meet its SCB within an expected timeframe for buffer restoration. The capital restoration plan should be shared with the PRA. The PRA will assess the executability of the plan and challenge assumptions made.</p>
<p>Own-Initiative Requirement (OIREQ) and Voluntary Requirements (VREQ)</p> <p>The PRA can ask a firm to voluntarily apply for the imposition of a new requirement to limit activities. Alternatively, section 55M(3) of the Financial Services and Markets Act 2000 allows the PRA to impose a new requirement on a firm, to vary a requirement that it has imposed on the firm or to cancel any such requirement other than on the application of a firm.</p>
<p>Own-Initiative Variation of Permissions (OIVOP) & Voluntary Variation of Permissions (VVOP)</p> <p>It may be appropriate to use the PRA's own-initiative variation of permission (OIVOP) power under section 55J of FSMA to change the firm's permissions in certain circumstances, or to agree a voluntary variation of permission with the firm (VVOP).</p>
<p>Distribution Policy</p> <p>The PRA expects firms to recognise that, generally, it would not be appropriate for a firm that is expecting to make significant use of its buffer to make distributions of capital to its shareholders or management team. However, the PRA recognises that there can be circumstances when it would be sensible for such distributions and the firms are expected to engage with their respective Supervision Team before making such decisions.</p>
<p>Recovery Plan</p> <p>Effective recovery planning makes a firm more resilient to financial stress. A recovery plan should include recovery options for responding to a range of stress scenarios. These recovery options should help the firm to restore itself to a stable and sustainable condition.</p>

The Supervision Team, along with PRA specialists, will assess the executability of the recovery plan, seeking to understand which recovery options are being pursued with what expected impact on both capital levels and business viability.

Section 166 ‘skilled persons’ reviews

Obtaining external assurance could be useful or essential at different stages of buffer usage. Circumstances in which Section 166 reports could be used include, but are not limited to:

Obtaining assurance that the Capital Restoration Plan is credible and achievable.

- Obtaining assurance that the management, governance, and controls are adequate to successfully execute the capital restoration plan.

Assessing the executability of a solvent wind-down plan.

Solvent Exit

A firm should produce a ‘solvent exit execution plan’ if and when the execution of a solvent exit becomes a reasonable prospect.²⁹ A firm should identify and monitor indicators that would inform it about when it needs to initiate a solvent exit and whether the execution of a solvent exit is likely to be successful.

²⁹ For further information see CP10/23 – Solvent exit planning for non-systemic banks and building societies, available at: <https://www.bankofengland.co.uk/prudential-regulation/publication/2023/june/solvent-exit-planning-for-non-systemic-banks-and-building-societies>