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Appendix 1: Draft amendments to SoP4/16 – The PRA's approach to the implementation of the O-SII buffer

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4.6 The PRA expects that it will exercise supervisory judgement to deviate from the O-SII buffer rates derived from the FPC framework or waive the requirement only in exceptional cases. The PRA expects that these will primarily be cases where the outcome of the methodology is not in adherence with the spirit of the FPC framework. An example of such a case could be actions by a firm to manipulate its systemic score deliberately, so that the rate derived from the framework underestimates its systemic importance. Other circumstances could include where a firm's leverage exposure measure has changed materially between the year-end and the point at which rates are set or are projected to grow by the time that the rates would take effect.

4.7 Additionally, the PRA could lower O-SII buffer rates in the event of a shock. In such cases, the PRA expects to lower O-SII buffer rates for firms, if it anticipates that they faced the prospect of losses that could otherwise lead them to restrict lending to defend capital positions, by more than was warranted by the economic outlook, and that the release by the FPC of the countercyclical capital buffer alone would be insufficient to absorb those losses. The PRA would make such a judgement in engagement with the FPC and consider a range of factors (as set out in Annex 1). When releasing the buffer, the PRA would provide an indicative period during which no increase in O-SII buffer rates would be expected.

Annex 1 – Release and rebuild scenarios in a systemic stress

Judgement and coordination

1.1 In line with the current approach to using supervisory judgement, the PRA expects to lower O-SII buffer rates only in exceptional circumstances. These circumstances include economic shocks. In such cases, the PRA expects to lower O-SII buffer rates for firms, if it anticipates that they faced the prospect of losses that could otherwise lead them to restrict lending to defend capital positions, by more than was warranted by the economic outlook, and that the release by the FPC of the countercyclical capital buffer alone would be insufficient to absorb those losses. The PRA would make such a judgement in engagement with the FPC. In assessing whether an O-SII buffer release for firms is appropriate in response to such a stress, the PRA will consider a range of factors, including:

- the nature, severity and expected duration of the shock;
- the condition of the UK financial system;
- the probability of another shock;
- actual and expected losses;

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- credit conditions and the availability of finance to creditworthy households and businesses;
- market functioning;
- firms' capital positions and capacity to absorb losses; and
- the risk that firms restrict lending or take other defensive actions to protect capital.

1.2 These factors do not constitute a mechanical test. Their relevance and weight depend on the circumstances. The PRA will make an overall assessment and will not seek to predetermine how it would exercise judgement in a future stress.

1.3 In the event of a shock, the PRA and FPC will engage closely and take account of each other's actions, while making decisions in line with their respective responsibilities.

Illustrative release scenarios

1.4 The PRA has outlined illustrative scenarios to explain how it could approach a decision on whether to release the O-SII buffer, building on the scenarios set out in the FPC's CCyB policy statement. The scenarios are not intended to prescribe the PRA's or the FPC's response to a future stress or to establish mechanical conditions for release. Any decision would be based on the PRA's overall assessment of the circumstances at the time.

1.5 The scenarios focus on whether firms subject to the O-SII buffer faced the prospect of losses that could otherwise lead them to restrict lending to defend capital positions, by more than was warranted by the economic outlook. Such behaviour could amplify the initial shock and ultimately increase losses for firms. The PRA would distinguish this from an appropriate adjustment in lending conditions that reflected changes in borrowers' creditworthiness and the economic outlook.

Scenario 1: A large shock originating outside the financial system.

1.6 A large external shock could cause a sharp fall in UK output and incomes and lead firms subject to the O-SII buffer to expect material losses. If those firms sought to protect their capital positions by restricting lending, their actions could amplify the effect of the shock on the real economy and give rise to further losses. In those circumstances, the FPC could release the UK CCyB to ease constraints across the banking system, while the PRA could consider reducing O-SII buffer rates for firms, including to zero. Releasing the O-SII buffer could give affected firms additional capacity to absorb losses and continue supplying credit without entering the part of their combined buffer in which automatic restrictions on distributions applied.

1.7 A reduction in the O-SII buffer would not represent an assessment that the firms concerned had become less systemically important. It would give firms the time to rebuild their capital position without unwarranted restrictions in lending, thereby reducing the risk that

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actions taken by systemically important firms amplified the effect of the shock. This is fully in line with the intent of the O-SII buffer in the capital stack.

Scenario 2: An escalating or multi-stage stress.

1.8 A stress could develop in stages. Initially, losses or tighter financial conditions might affect the banking system broadly, leading the FPC to release the UK CCyB. At that stage, the PRA – in engagement with the FPC – might judge that releasing the CCyB was sufficient to support loss absorption and the continued provision of credit without the release of the O-SII buffer, when assessed alongside firms' existing capital resources and other policy measures.

1.9 If the stress subsequently intensified, further shocks occurred, or the pressures on firms subject to the O-SII buffer became more pronounced, the PRA could reconsider that assessment. It could reduce O-SII buffer rates if it judged that the additional release of capital would materially reduce the risk that affected firms restricted lending to defend capital positions, preventing some creditworthy households and businesses from accessing funding. The decision would depend on the marginal benefit of releasing the O-SII buffer in the circumstances, taking account of the temporary reduction in structural resilience and the possibility of further shocks.

Scenarios in which the O-SII buffer would be unlikely to be released.

1.10 The PRA would not expect to reduce the O-SII buffer rates if it judges that the banking system does not face the prospect of losses that could otherwise lead it to restrict lending to defend capital positions in a shock. This could be the case in a mild economic downturn or one in which the CCyB were judged to be sufficient to absorb losses. Or this could be the case during financial market stress if firms to which O-SII buffers apply were not expected to incur losses significant enough for them to restrict lending to households and businesses. Similarly, shocks elsewhere within the financial system (for example, to non-bank financial institutions) are only likely to warrant a reduction in O-SII buffer rates if they pose a significant threat to firms subject to the O-SII buffer and their ability to continue supplying credit to the real economy.

1.11 An FPC decision to release the UK CCyB would not automatically lead to release of the O-SII buffer. The two authorities would make decisions in accordance with the frameworks governing their respective statutory powers and responsibilities. The PRA would consider whether an additional reduction in requirements applying to firms subject to the O-SII buffer was necessary and appropriate in the circumstances.

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Indicative period and rebuilding the O-SII buffer

Indicative period

1.12 At the time of release, the PRA will provide an indicative period during which no increase in O-SII buffer rates would be expected, consistent with the FPC's approach to the CCyB. This will give firms greater certainty that the released capital could be used to absorb losses and support lending rather than having to be rebuilt immediately. In setting that period, the PRA will take account of the nature and expected duration of the stress and relevant actions by the FPC, including any indicative period applying to the UK CCyB.

1.13 The indicative period would not create an automatic timetable for rebuilding. During that period, the PRA will monitor economic and financial conditions, the supply of credit, realised and expected losses, firms' profitability and capital generation, and the likelihood of further stress. It will also take account of the possibility that impairments could emerge with a lag after the initial shock had passed. The PRA could extend the indicative period if it judged that conditions did not yet support rebuilding.

Rebuild approach

1.14 By the end of the indicative period, the PRA will assess whether firms could begin rebuilding the O-SII buffer while continuing to lend to creditworthy households and businesses. The timing and pace of the rebuild would reflect the strength and expected path of the recovery, prevailing financial and credit conditions, realised and expected losses, firms' profitability and capacity to generate capital, the outlook for their capital positions, and relevant FPC decisions, including the pace of rebuilding the UK CCyB. The PRA will also consider whether firms had incurred the losses anticipated when the buffer was released and the extent to which the released capital had been used.

1.15 Rebuilding the O-SII buffer will typically take place over a multi-year period. The PRA will seek to avoid a pace or combination of increases that placed unnecessary pressure on firms to restrict lending or raise external capital during the recovery. At the same time, it would take account of the benefits of restoring firms' structural resilience so that they were able to absorb future shocks.

1.16 When the PRA increases the O-SII buffer rates in stages, firms will have 12 months, in general, before each rate in each stage must be met. The PRA may set a shorter implementation period in exceptional circumstances.

1.17 The PRA and FPC will make decisions in accordance with the frameworks governing their respective statutory powers and responsibilities and taking account of each other's actions.

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Illustrative rebuild scenarios

Scenario 1: Strong recovery, limited losses and limited buffer use.

1.18 The economic shock could be more benign than anticipated, or the economy and credit conditions could recover more quickly than expected, while firms experienced limited losses and made little use of the capital released. If profitability and capital generation were robust, firms might be able to meet higher O-SII buffer rates largely from existing capital or a share of retained earnings, without constraining lending or needing to raise external capital. In those circumstances, the PRA could rebuild the buffer relatively quickly. Even in this scenario, the rebuild would typically occur over a multi-year period and take into account the time between an increase in the O-SII buffer rate being announced and it being met by firms.

Scenario 2: A gradual recovery.

1.19 The stress could subside and profitability resume, while capital generation remained moderate and credit conditions continued to normalise. Firms might be capable of rebuilding capital, but a rapid increase in requirements could reduce their capacity or willingness to lend. In those circumstances, the PRA could rebuild the O-SII buffer gradually over a multi-year period, taking account of firms' ability to meet higher rates through a share of retained earnings while continuing to support creditworthy households and businesses.

Scenario 3: Weak recovery, material losses or continuing uncertainty.

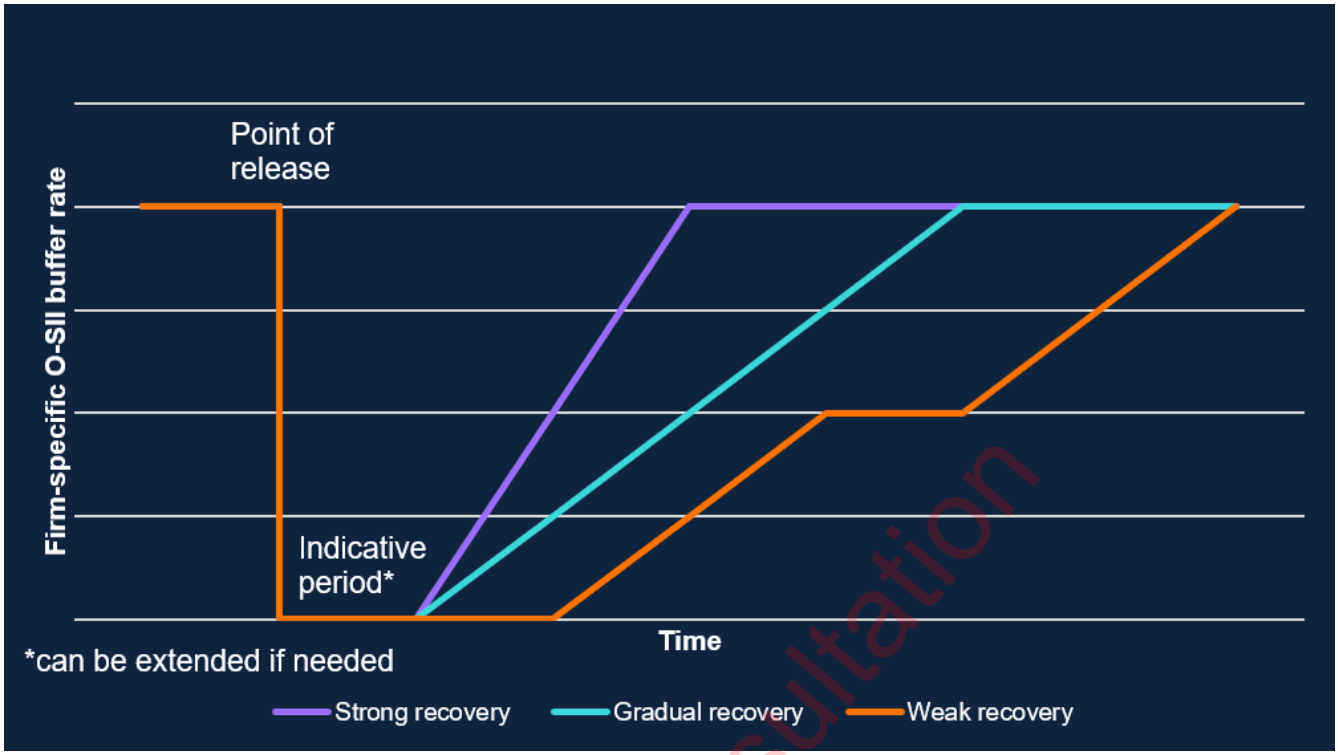
1.20 The stress could be followed by a weak recovery in which firms had incurred material losses, profitability and capital generation remained subdued, or further impairments continued to emerge. Rebuilding the O-SII buffer too quickly in those circumstances could encourage firms to restrict lending or take other defensive actions, potentially slowing the recovery and generating additional losses. The PRA could therefore extend the initial indicative period or rebuild the buffer over a longer period than in the other scenarios.

1.21 These scenarios illustrate the factors that could affect the pace of rebuilding but do not define exhaustive categories or bind the PRA's future decisions. Actual conditions might combine features of more than one scenario, and circumstances could change during the rebuild. The PRA would therefore keep the timing and pace of the rebuild under review and could adjust its approach if the economic or financial outlook changed materially. Chart 1 provides a qualitative illustration of how the O-SII buffer could be released and subsequently rebuilt under the scenarios described above.

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Chart 1: Illustrative pace of O-SII buffer rebuild



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