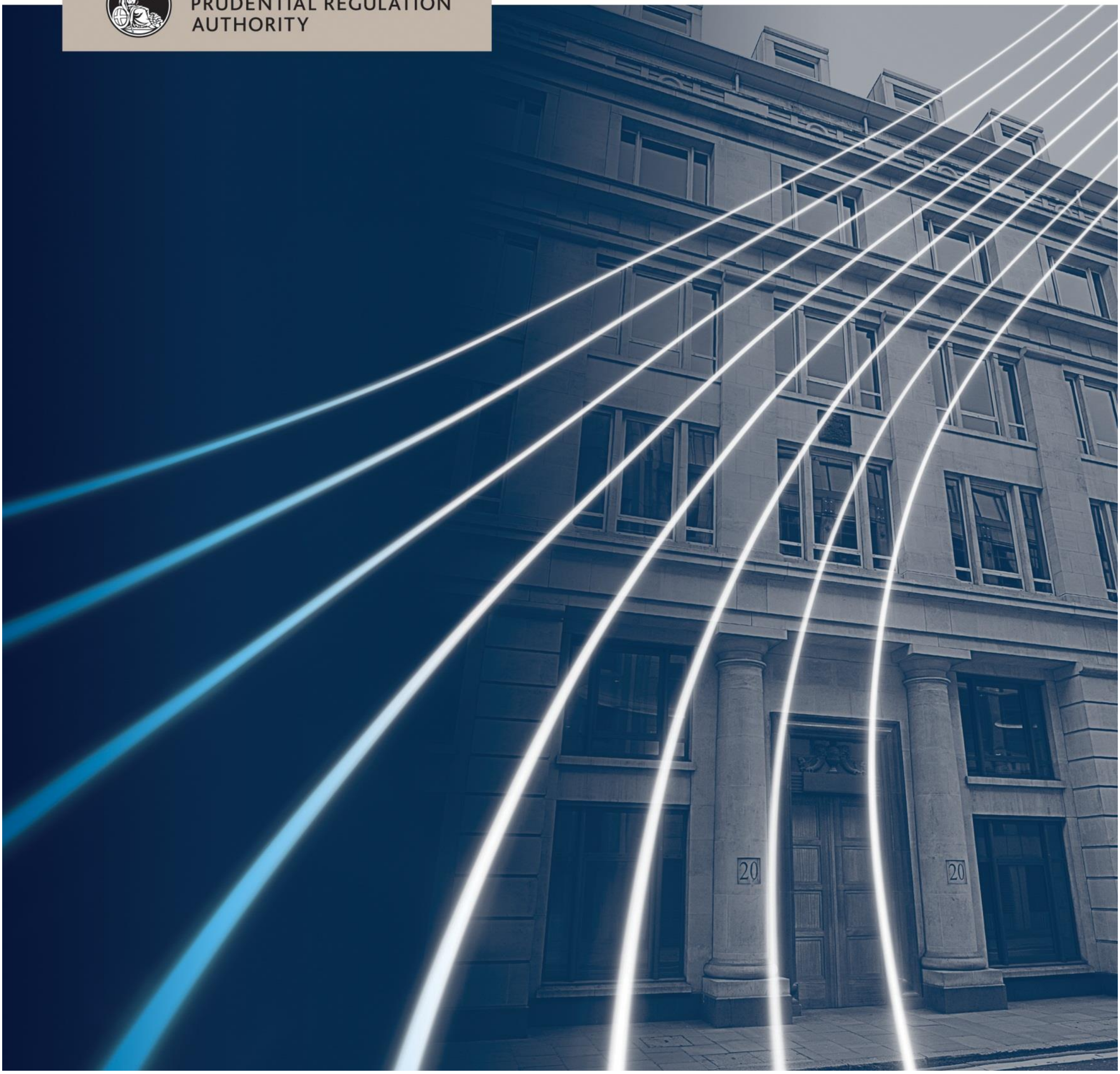
Policy Statement | PS25/16

Implementing risk-based levies for the Financial Services Compensation Scheme deposits class

September 2016

BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY



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This policy statement provides feedback on responses, final rules and a statement of policy following Consultation Paper 7/16 'Implementing risk-based levies for the Financial Services Compensation Scheme deposits class'.

1 Overview

1.1 This Prudential Regulation Authority (PRA) policy statement (PS) provides feedback on responses to Consultation Paper (CP) 7/16 'Implementing risk-based levies for the Financial Services Compensation Scheme deposits class' ('CP7/16').[1] Appendix 1 of this PS contains the amendments to the Depositor Protection Part of the PRA Rulebook. Appendix 2 contains the final statement of policy specifying the calculation methodology for risk-based levies.

1.2 This PS is relevant to UK banks, building societies and credit unions as well as to overseas firms with PRA deposit-taking permission; and the Financial Services Compensation Scheme (FSCS), as the UK's administrator of its Deposit Guarantee Scheme (DGS).

1.3 In response to consultation feedback, the PRA has removed the proposal that legacy cost levies are risk-based. The PRA has also made technical amendments to the calculation methodology for credit unions to align with the requirements in the Credit Union Part of the PRA Rulebook.

1.4 The PRA is required by the Financial Services and Markets Act 2000 (FSMA) to publish a statement on the impact of rules on mutuals where the final rule differs from the draft of the proposed rule.[2] In the PRA's opinion, the impact of the rules as made is not significantly different from the impact of the proposed rules on mutuals or other deposit-takers. The technical amendments made to the calculation model for credit unions are designed to achieve an outcome consistent with other firms.

1.5 Section 138J(5) of FSMA requires the PRA to publish a cost benefit analysis of any changes to the consultation proposals which the PRA considers to be significant.

1.6 As noted in paragraphs 2.5-7, the PRA has removed legacy costs from the risk-based calculation. This will make firms' levies more predictable and aid their budgeting processes. The change will not introduce additional costs to the sector.

1.7 As outlined in paragraph 2.16, the PRA has also adjusted the credit union calculation to reflect consultation feedback and changes made to the Credit Union Part of the PRA rulebook in PS4/16 'Reform of the legacy Credit Unions sourcebook'.[3] The level of the total compensation cost for all firms will be unaffected by this change, and any alteration in an individual credit union's levy will more accurately reflect their risk to the FSCS.

1 March 2016: www.bankofengland.co.uk/pra/Pages/publications/cp/2016/cp716.aspx.
2 Section 138K of FSMA.
3 February 2016: www.bankofengland.co.uk/pra/Pages/publications/ps/2016/ps416.aspx.

2 Feedback to responses

2.1 The PRA is required by FSMA to have regard to any representations made to the proposals in a consultation, to publish an account, in general terms, of those representations and its response to them, and to publish details of any significant differences in the rules as made.

2.2 In CP7/16 the PRA consulted on amendments to the Depositor Protection Part of the PRA Rulebook and a new statement of policy in relation to the calculation of firm contributions to the FSCS. The changes arise from the requirement in Article 13 of the recast Deposit Guarantee Schemes Directive (DGSD)[1] to adjust firm contributions to DGSs for the degree of risk incurred by each DGS member.

2.3 In CP7/16 the PRA proposed:

- amendments to the rules governing the funding of the FSCS in Chapters 34, 39 and 42 of the Depositor Protection Part that would require the FSCS to adjust compensation cost levies for the degree of risk incurred by a DGS member. These would take effect from the 2017 levy cycle;
- amendments to rules in Chapter 36 of the Depositor Protection Part requiring the FSCS to similarly risk-adjust legacy cost levies; and
- a new statement of policy, specifying how the PRA intends to calculate the degree of risk incurred by a DGS member. The PRA proposed different calculation methodologies for Capital Requirements Regulation (CRR) firms, credit unions and non-EEA branches due to their different legal and supervisory regimes.

2.4 Respondents to CP7/16 were supportive of the principle of adjusting the compensation cost levy to take into account the degree of risk incurred by each firm. Feedback focussed on the approach to legacy costs and the calibration of the risk indicators in the calculation methodologies for CRR firms and credit unions. These are discussed below.

Legacy costs

2.5 In CP7/16, the PRA proposed that legacy cost levies should be included in the scope of the risk-based methodology as one single, consistent approach across both compensation and legacy cost levies would be the simplest both for firms and the FSCS.

2.6 Respondents argued that while there was logic to this approach, it is not a strict requirement of the DGSD, makes forecasting levies and budgeting more difficult for firms, and is inappropriate since there is a large distance between the incidence of these costs and firms' current risk profiles. Respondents highlighted that maintaining two separate systems would not add complexity to the ongoing levy process.

2.7 In light of this feedback, the PRA agrees that removing legacy cost levies from the risk-based methodology is a proportionate response and has revised the proposed rules and statement of policy to reflect this approach.

1 Directive 2014/49/EU, Deposit Guarantee Schemes Directive; http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014L0049.

The CRR firm model

2.8 Respondents largely agreed with the PRA's proposals for the calculation methodology for CRR firms, but suggested certain amendments to the calibration of the risk indicators.

2.9 Some respondents argued that different weights should be assigned to the risk indicators. Since the PRA did not propose to include any additional indicators beyond the core risk indicators specified by the EBA Guidelines (GLs), these weights cannot be amended: where only core risk indicators are used the weight of each is prescribed in the GLs.[1]

2.10 Some respondents argued that the calibration of the capital, liquidity and leverage risk indicators produced too little differentiation between firms' risk scores since they are aligned only to firm minimum requirements. Respondents suggested alternative approaches including a sliding scale or calibration with respect to firm-specific requirements for these indicators.

2.11 The PRA recognises the underlying logic to the feedback from respondents on this point, however, the PRA does not consider that the alternative approaches suggested by respondents are appropriate at this stage.

2.12 Across all three indicators, a sliding scale would mechanically reward firms with higher ratios, which is not necessarily reflective of the risks each firm incurs. Calibrating with respect to individual requirements across the indicators is not appropriate at this stage since the PRA recently consulted on its Pillar 2 liquidity proposals,[2] and DGS members are not set individual leverage ratio requirements.

2.13 The PRA is therefore of the view that it is not proportionate to introduce additional complexity in advance of the EBA review of the GLs in 2017. The PRA will reconsider the calibration as part of the review process, and will consult on any proposed changes to the calculation methodology.

2.14 For the indicators where the PRA proposed a relative bucketing approach (Non-preforming loan ratio, risk-weighted assets (RWA)/total assets and return on assets (RoA)), some respondents argued that the number of buckets (five) would segment the firm population excessively, particularly for firms using the Internal Ratings Based (IRB) approach to credit risk (for the RWA/total assets indicator) and mutuals (for the RoA indicator).

2.15 The PRA is of the view that reducing the number of buckets would inappropriately exaggerate differences between firms with similar risk indicator outturns (by increasing the difference in risk scores between adjacent buckets), and so has chosen to implement the proposal for a five bucket approach.

The credit union model

2.16 Respondent feedback suggested adjusting the calibration of the risk indicators in the credit union model to align with the liquidity and capital requirements in the Credit Union Part of the PRA Rulebook, and excluding grant income from the net income figure used to calculate the RoA risk indicator. The PRA agrees with this feedback and has made the relevant alterations to the calculation methodology in the statement of policy.

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1 'Guidelines on methods for calculating contributions to deposit guarantee schemes' available at: www.eba.europa.eu/documents/10180/1089322/EBA-GL-2015-10+GL+on+methods+for+calculating+contributions+to+DGS.pdf.

2 Consultation Paper 21/16 'Pillar 2 liquidity', May 2016: www.bankofengland.co.uk/pra/Pages/publications/cp/2016/cp2116.aspx.

Appendices

1	**PRA Rulebook: CRR Firms, Non CRR Firms, Non-Authorised Persons: Depositor Protection Instrument 2016, available at www.bankofengland.co.uk/pra/Pages/publications/ps/2016/ps2516.aspx**
2	**Statement of Policy 'Calculating risk-based levies for the Financial Services Compensation Scheme deposits class', available at www.bankofengland.co.uk/pra/Pages/publications/sop/2016/calculatingrbl.aspx**