

Policy Statement | PS9/18

Groups policy and double leverage

April 2018



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Contents

1.	Overview	5
2.	Feedback to responses	6
Appendices		11

1. Overview

1.1 This Prudential Regulation Authority (PRA) Policy Statement (PS) provides feedback on responses to Consultation Paper (CP) 19/17 'Groups policy and double leverage'.¹

1.2 It contains updates to:

- Rule 14.10 of the PRA Rulebook CRR Firms: 'Internal capital adequacy assessment (No.2) instrument 2018' (Appendix 1);
- Supervisory Statement (SS) 31/15 'The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)' (Appendix 2);
- Statement of Policy (SoP) 'The PRA's methodologies for setting Pillar 2 capital' (Appendix 3); and
- SS24/15 'The PRA's approach to supervising funding and liquidity risks' (Appendix 4).

1.3 This PS is relevant to PRA-authorized UK banks, building societies, PRA-designated UK investment firms and their qualifying parent undertakings (QPU),² as well as credit institutions, investment firms and financial institutions that are subsidiaries of these firms, regardless of their location.

1.4 As part of its review of the groups policy framework, the PRA also issued CP20/17 'Changes to the PRA's large exposures framework'.³ The consultation period closed on Thursday 4 January 2018. The PRA is now considering responses and will publish its final policy in the summer.

Background

1.5 Following a review of the groups policy framework, the PRA set out in CP19/17 a collection of proposals intended to ensure that banking groups have appropriate financial resources to cover the prudential risks of the whole group. The proposals covered:

- (i) assessment and mitigation of the risks to group resilience due to 'double leverage';
- (ii) assessment and mitigation of the risks highlighted by prudential requirements applied by local regulatory authorities on overseas subsidiaries of UK consolidation groups; and
- (iii) improved monitoring of the distribution of financial resources across different group entities.

Summary of responses

1.6 The PRA received three responses to the CP. Respondents supported the overarching principle that consolidated capital requirements should take into account all risks that a group faces and that the financial strength of the holding company is of great importance. They sought clarity on certain aspects of the proposals, which are set out by theme in Chapter 2 below.

1 October 2017: www.bankofengland.co.uk/prudential-regulation/publication/2017/groups-policy-and-double-leverage.

2 QPU has the meaning in section 192B of the Financial Services and Markets Act (FSMA) 2000 which, in summary, is a UK parent undertaking of a PRA-authorized person or an investment firm. As contained in the FSMA Act 2000 (Prescribed Financial Institutions) Order of 2013, the definition of QPUs includes financial holding companies and mixed financial holding companies.

3 October 2017: www.bankofengland.co.uk/prudential-regulation/publication/2017/changes-to-the-pras-large-exposures-framework.

Changes to the draft proposals

1.7 Following feedback, the PRA has made changes to its proposals regarding SS31/15 'The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)'⁴ in the following areas:

- a change to the definition of double leverage so that it is accounting-based (with a few regulatory adjustments) to reflect the reporting practices of stand-alone holding companies in paragraph 3.29 and 3.29A; and
- a clarification in paragraph 3.30 on the level of application of the double leverage formula.

1.8 The PRA has also amended the formula for double leverage, referred to in paragraph 8A.2A of SoP 'The PRA's methodologies for setting Pillar 2 capital'⁵ to align it with the revised wording in SS31/15.

1.9 The PRA does not consider the changes to be significant and, as a result, has not updated the assessment of the impact on mutuals or the cost benefit analysis (CBA) from CP19/17.

Implementation

1.10 The final rule, updated SS31/15, SS24/15, SoP will come into effect from Tuesday 1 January 2019. Where practical and applicable, firms should continue to aim to incorporate the policy proposals in their ICAA and Individual Liquidity Adequacy Assessment (ILAA) submissions ahead of full implementation.

1.11 The policy contained in this PS has been designed in the context of the current UK and EU regulatory framework. The PRA will keep the policy under review to assess whether any changes would be required due to changes in the UK regulatory framework, including changes arising once any new arrangements with the European Union take effect.

2. Feedback to responses

2.1 The PRA is required by the Financial Services and Markets Act 2000 (FSMA) to have regard to any representations made to the proposals in a consultation, and to publish an account, in general terms, of those representations and its response to them.

2.2 The sections below have been structured broadly along the same lines as the chapters of the CP. The responses have been grouped as follows:

- double leverage;
- group risk; and
- other responses.

4 December 2017: www.bankofengland.co.uk/prudential-regulation/publication/2013/the-internal-capital-adequacy-assessment-process-and-supervisory-review-ss.

5 April 2018: www.bankofengland.co.uk/prudential-regulation/publication/2015/the-pras-methodologies-for-setting-pillar-2-capital.

Double leverage

Definition of double leverage

2.3 One respondent proposed an alternative Tier 1 based definition of double leverage, arguing that the cancellation features of Additional Tier 1 (AT1) capital make it similar to Common Equity Tier 1 (CET1) capital from a cash-flow perspective.

2.4 The PRA has decided to maintain its definition on a common equity basis. The PRA emphasises that it has not set a general limit for the double leverage ratio. A general limit is not risk sensitive and therefore would not take into account an individual firm's risk profile and drivers of double leverage. The PRA's assessment approach places the onus on firms to quantify and explain their use of double leverage and how they manage the related risks. This includes assessing the risks associated with the mismatch between cash and capital inflows, and outflows of the QPU. The analysis, where relevant, should also appropriately reflect the AT1 features in the baseline and stress scenarios as part of firms ICAA or ILAA submissions, where appropriate. The PRA will consider the information provided by firms and determine whether it is satisfied that they are managing the risks of double leverage effectively, and that the level of double leverage does not threaten the safety and soundness of PRA-authorised entities in their groups. Depending on the outcome of the review, the PRA may set a specific limit on the amount of double leverage a firm's QPU can use, although it may consider other supervisory measures as well.

Accounting-based definition of double leverage

2.5 Respondents sought clarity on the use of CET1 capital in the definition, as it was noted that CET1 is not a concept that exists at the level of the QPU.

2.6 The PRA acknowledges that the regulatory CET1 definition does not apply to an unregulated QPU. Therefore, the PRA has defined double leverage in accounting capital terms, incorporating relevant regulatory adjustments as set out in paragraph 3.29 and 3.29A of SS31/15. The revised definition will require firms to adjust their shareholders' equity by deducting intangible assets, deferred tax assets and AT1 capital. While firms can continue using their own measures, the PRA also expects them to monitor risks of double leverage on the basis of the PRA definition.

Level of application

2.7 The PRA has decided to clarify the level of application of the double leverage definition. The PRA has included this clarification in paragraph 3.30 of SS31/15. The double leverage ratio should be calculated at the level of each QPU, as well as at an aggregate level. The aggregate double leverage ratio will provide the PRA with an indicator of the overall levels of double leverage of the group. This will also promote comparability across groups. This means that if double leverage arises at the top holding company, as well as at an intermediate holding company, the ratio would reflect both. The PRA does not deem the clarification a material change from the proposals in the CP.

Scope of proposals

2.8 One respondent requested more clarity on the scope of the double leverage policy.

2.9 The double leverage policy covers firms for which the PRA is the global consolidating supervisor. This was covered in paragraph 3.32 of SS31/15.

2.10 The PRA reminds firms that supervisors have discretion to request analysis of group risk and double leverage from firms that are not covered by paragraphs 3.32 and 2.16AE of SS31/15 if they deem it necessary.

European policy developments

2.11 One respondent asked whether the PRA had considered the impact of ongoing European policy developments, particularly on authorising holding companies. The respondent referred to the European Commission's Capital Requirements Directive (CRD) V package, requiring authorisation of holding companies (Article 21a).

2.12 CRD V remains a proposal, and no final text has been agreed on Article 21a. The PRA stated in CP19/17 paragraph 1.15 that the proposals have been designed in the context of the current UK and EU regulatory framework. The PRA has also stated that the policy proposal will be kept under review to assess whether any changes are required as a result of a potential change in the UK regulatory framework.

Rationale for development of policy

2.13 One respondent questioned the need for a double leverage policy at this time.

2.14 The PRA considers that the development of a comprehensive groups policy is necessary as post-crisis regulatory reforms, including Basel III standards, UK ring-fencing legislation, the resolution framework and other international developments, have led to a generalised increase in the aggregate level of solo and sub-consolidated requirements relative to consolidated group requirements. In some instances, this may reveal that consolidated group requirements do not fully or adequately capture all of the groups' risks, or increase the incentives for groups to use double leverage.

Impediments to transfer of funds

2.15 One respondent noted whether there was policy consistency between the requirements in paragraph 3.31 of SS31/15 related to reporting inflows under stress and the requirements in paragraph 2.11 of the draft amendments to SS16/13 'Large Exposures'⁶, that call for an attestation that there are no impediments to the transfer of funds or repayment of liabilities to be provided by the parent undertaking and the relevant group entities.

2.16 The PRA has not amended the requirements set in SS31/15 as the PRA does not consider them to be inconsistent with the draft amendments to SS16/13. No impediment to the transfer of funds or repayments of liabilities is a necessary condition for granting intragroup large exposure permissions. Paragraph 3.31 of SS31/15 requires management to identify scenarios where capital inflows to parent undertaking from their subsidiaries may be significantly reduced in times of stress. This may occur without any impediments to the transfer of funds or repayment of liabilities, for example, where the subsidiary is not profitable. The PRA considers that the two requirements assess different risks within banking groups. However, the assessment carried out in accordance with paragraph 3.31 of SS 31/15 may point to impediments to the transfer of funds or repayment of liabilities that would need to be considered in relation to intragroup large exposure permissions.

Group risk

Prudential requirements applied by a host regulator

2.17 Respondents agreed that group capital requirements should consider all prudential risks that a group faces. One respondent requested further clarification on the types or risks the PRA believes might not be adequately capitalised at the consolidated (group) level.

6 December 2013: www.bankofengland.co.uk/prudential-regulation/publication/2013/large-exposures-ss.

2.18 The PRA applies prudential requirements to firms on an individual, sub-consolidated, and consolidated basis. Requirements applied at an individual level can be higher than the consolidated requirements when aggregated. This could be due to a number of factors, one being the different requirements imposed by local jurisdictions. CP19/17 established an expectation that consolidated capital requirements may have to be increased to include certain risks capitalised for at the individual (solo) level that have not been adequately captured in consolidated capital requirements.

2.19 The PRA provided an example of such a risk in the footnote to paragraph 2.16AC of SS31/15. The extent to which any domestically systemically important bank (D-SIB) buffer exceeds the D-SIB's share of any group-wide global systemically important bank (G-SIB) buffer would need to be reflected in the consolidated group requirements. The PRA considers that given that firms have different business models, the risks will vary across firms; hence it would not be relevant or practical to publish an exhaustive list.

Allocation of resources amongst group entities

2.20 One respondent suggested that there are already existing requirements that address the risk of capital misallocation, such as the solo deductions for material investments in subsidiaries, the Connected Funding of a Capital Nature (CFCN) requirements and the large exposures regime.

2.21 The measures mentioned in the response ensure the safety and soundness of the regulated individual entities, whereas this policy is designed to address this risk of entities within groups being under-resourced for the size of the risks they face. Paragraph 3.8 of CP19/17 stated that these under-resourced entities are likely to be unregulated individual entities within the banking group. Paragraph 3.9 further states that unregulated entities could pose risks to authorised firms in the same consolidation group, through both direct losses, and through reputational and financial contagion effects.

2.22 Furthermore, one respondent has requested a materiality threshold for such entities, to avoid additional assessments being overly burdensome and being proportionate to other risks.

2.23 CP19/17 proposed a materiality threshold for entities, for which there is an under-allocation of capital, in paragraph 2.16AB of SS31/15. The threshold is set at 5% (measured as a contribution to the consolidation group's risk weighted assets (RWA)). The final policy includes this threshold.

Group risk capital add-on for the ring-fenced bank (RFB)

2.24 One respondent expressed a view that the ring-fenced bank add-on should not be applied at the group level, since all risks are diversified at the group level.

2.25 The PRA did not cover this proposal in CP19/17; PS3/17⁷ covers this issue.

Supervisory judgement

2.26 One respondent noted that the proposals in the CP could allow for arbitrary supervisory judgement to determine the amount of group risk that might arise. The PRA has interpreted this to mean that there is concern around arbitrary capital add-ons that might be imposed on firms by the PRA.

7 'The implementation of ring-fencing: reporting and residual matters – responses to CP25/16 and Chapter 5 of CP26/16', February 2017: www.bankofengland.co.uk/prudential-regulation/publication/2017/the-implementation-of-ring-fencing-reporting-and-residual-matters-responses-to-cp2516-and.

2.27 Firms are expected to include their assessments of group risk and double leverage as part of their annual ICAA submissions. The Supervisory Review Process (SREP) is a comprehensive and well-established process. The methodologies and the different factors taken into account are described in detail in SS31/15. The SREP is proportionate to the nature, scale and complexity of firms' activities.

2.28 With respect to the group risk and double leverage policy, a capital add-on may not always be optimal. The PRA's proposals are targeted at better understanding the sources of group risk and ensuring that capital is appropriately allocated across the group. More specifically, the PRA does not consider that there is a potential for arbitrary supervisory judgement. For example, should there be a case of excessive double leverage that gives rise to payment and maturity mismatch risks that are not adequately managed and mitigated, the PRA has indicated in paragraph 8A.2B of the SoP that it would set firm-specific limits to the permissible use of double leverage.

Other responses

Solo deductions regime

2.29 One respondent recommended that the PRA reconsiders its approach to solo deductions of investments in subsidiaries, as the approach is perceived to be overly prudent and not risk sensitive.

2.30 This issue is out of scope for CP19/17.

Cost benefit analysis

2.31 A respondent has requested more information on the approach taken by the PRA in the design of the cost benefit study and the estimate of 9 basis points of additional cost in particular.

2.32 The CBA is based on the expected impact of any differences between consolidated requirements and requirements imposed by local regulatory authorities. From the data received by a sample of firms, the PRA concluded that on average due to differences in home and host regulatory requirements, banking groups would need to raise, on aggregate, about 0.09%, as a percentage of group RWAs, of additional equity capital. The PRA cannot disclose more details for confidentiality reasons. The PRA does not claim that it has knowledge of all risks that could be included in the analysis. This is why, as part of the groups and double leverage proposals, the PRA has requested more information on the sources of risks to firms.

Appendices

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- 1 **PRA RULEBOOK: CRR FIRMS: INTERNAL CAPITAL ADEQUACY ASSESSMENT (No. 2) INSTRUMENT 2018** available at: www.bankofengland.co.uk/prudential-regulation/publication/2017/groups-policy-and-double-leverage

 - 2 **Supervisory Statement 31/15 UPDATE 'The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)'** available at: www.bankofengland.co.uk/prudential-regulation/publication/2013/the-internal-capital-adequacy-assessment-process-and-supervisory-review-ss

 - 3 **Statement of Policy UPDATE 'The PRA's methodologies for setting Pillar 2 capital'** available at: www.bankofengland.co.uk/prudential-regulation/publication/2015/the-pras-methodologies-for-setting-pillar-2-capital

 - 4 **Supervisory Statement 24/15 UPDATE 'The PRA's approach to supervising liquidity and funding risks'** available at: www.bankofengland.co.uk/prudential-regulation/publication/2015/the-pras-approach-to-supervising-liquidity-and-funding-risks-ss