



## Systemic Risk Buffers and Pillar 2A in stress test hurdle rates

In 'Key elements of the 2018 stress test' March 2018, the Bank of England ('the Bank') noted its intention to change the way hurdle rates are calculated in the annual stress test in four ways.<sup>1</sup>

This statement provides further specific details on two of these changes, that:

1. hurdle rates will incorporate buffers to capture domestic systemic importance as well as global systemic importance; and
2. the calculation of minimum capital requirements incorporated in the hurdle rates will more accurately reflect how they would evolve in a real stress.

These changes are only relevant to CRR firms.<sup>2</sup>

### Systemic Risk Buffer rates

The Systemic Risk Buffer (SRB) increases the capacity of certain UK systemic banks to absorb stress, reflecting their significance for the domestic economy.<sup>3</sup> Beginning in 2019, SRB rates will be set for ring-fenced banks (RFB) and large building societies (together, 'SRB institutions') by the Prudential Regulation Authority (PRA), following the methodology created by the Financial Policy Committee (FPC).

The PRA expects to calculate an uplift to firms' risk-weighted hurdle rates following the approach to setting Pillar 2B for RFB group risk, as set out in the PRA's Statement of Policy on its methodologies for setting Pillar 2 capital.<sup>4</sup> Subject to the outcome of PRA consultation, the PRA expects to also calculate an uplift to leverage ratio hurdle rates following the approach for calculating a leverage ratio group add-on, as proposed in CP14/18 'UK leverage ratio: Applying the framework to systemic ring-fenced bodies and reflecting the systemic risk buffer'. Any impact on firms' hurdle rates will depend on whether the firm is subject to the global systemically important institution buffer (G-SII buffer), and if so the rate of the G-SII buffer.

For the purpose of the 2018 stress test, in calculating these uplifts to firms' hurdle rates the PRA will assume the following SRB rates for the SRB institutions: Barclays 1%; HSBC 1%; Lloyds Banking Group 2.5%; Nationwide 1%; RBS 1.5%; and Santander UK 1%. These are assumed rates for concurrent stress-test purposes only. Actual SRB rates for affected firms will be determined and published for the first time in 2019.

### New approach for the inclusion of Pillar 2A in hurdle rates

The Bank's annual stress test uses a risk-weighted hurdle rate which includes Pillar 2A. Pillar 2A is a minimum capital requirement applied to cover a range of risks not (or not adequately) captured in Pillar 1.<sup>5</sup> It is reset every year for institutions participating in the Bank's annual stress test. Once set, Pillar 2A is expressed as a percentage of total risk

---

<sup>1</sup> March 2018: available on the Bank's website at [www.bankofengland.co.uk/news/2018/march/key-elements-of-the-2018-stress-test](http://www.bankofengland.co.uk/news/2018/march/key-elements-of-the-2018-stress-test).

<sup>2</sup> Those to which the Capital Requirements Directive (2013/36/EU) (CRD) and Capital Requirements Regulation (575/2013) (CRR) – jointly 'CRD IV' apply.

<sup>3</sup> See The Financial Policy Committee's framework for the systemic risk buffer, May 2016.

[www.bankofengland.co.uk/-/media/boe/files/paper/2016/the-financial-policy-committees-framework-for-the-systemic-risk-buffer](http://www.bankofengland.co.uk/-/media/boe/files/paper/2016/the-financial-policy-committees-framework-for-the-systemic-risk-buffer)

<sup>4</sup> See PRA Statement of Policy 'The PRA's methodologies for setting Pillar 2 capital', April 2018 (Section II: Pillar 2B): [www.bankofengland.co.uk/prudential-regulation/publication/2015/the-pras-methodologies-for-setting-pillar-2-capital](http://www.bankofengland.co.uk/prudential-regulation/publication/2015/the-pras-methodologies-for-setting-pillar-2-capital).

<sup>5</sup> PRA Statement of Policy 'The PRA's methodologies for setting Pillar 2 capital', April 2018, as in footnote 4.

weighted assets (RWAs) with the exception of pension risk which is expressed as a fixed nominal (£/\$) amount.

In previous stress tests, the Pillar 2A element of the hurdle rate has been set as a constant share of risk-weighted assets over the five year stress horizon. However, many of the risks reflected in Pillar 2A are not closely related to the size of a firm’s RWAs. Any divergence between the underlying Pillar 2A risks and total RWAs is expected to grow over time (eg over the five years of the stress test) and when average risk weights are more volatile (as is the case in the stress test).

To ensure the Pillar 2A requirements in the 2018 stress test reflect more closely the probable impact of the stress on the risks captured in Pillar 2A, the Prudential Regulation Committee (PRC) has developed an approach in which each Pillar 2A risk component scales with a simple metric (Table 1). For example, Pillar 2A requirements for credit risk will scale with changes in credit risk RWAs rather than total RWAs. This approach will also preserve, as far as is possible, the current simplicity in the calculation of hurdle rates.

These scaling bases are not intended to be ‘forward guidance’ on how the PRA will set Pillar 2A requirements in such a scenario; 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.

**Table 1 – Pillar 2A scaling bases**

<b>Risk type</b>	<b>Scaling base</b>
Operational risk <sup>6</sup>	Total assets
Pension risk	No scaling – remains a fixed add-on
Interest rate risk in the banking book (IRRBB)	Total banking book assets
Credit concentration risk	Credit RWAs
Market and counterparty credit risk <sup>7</sup>	Market RWAs
Credit risk	Credit RWAs
RFB group risk	No scaling – remains a fixed add-on
Other risks	As appropriate

Table 1 covers the material risks captured by Pillar 2A requirements for the firms participating in the annual stress test. For other risks, the PRA will consider the best scaling base to apply while maintaining the simplicity of the new calculation.

***PRA buffer setting***

For some firms, an additional capital buffer (the ‘PRA buffer’) is applied to cover losses that may arise under a severe stress scenario,<sup>8</sup> while avoiding duplication with other capital buffers. The size of the PRA buffer is informed by the result of the annual stress test.

<sup>6</sup> Including information technology risk.

<sup>7</sup> The Pillar 2A requirement for counterparty credit risk typically relates to the market risk aspect of counterparty credit risk. The credit risk component would typically be captured in credit concentration risk requirements.

The change to risk-weighted hurdle rates outlined above will affect the stress test results. In general, the scaling base metrics in Table 1 tend to increase less during the stress test than total RWAs. This means that, on average, hurdle rates are expected to be lower than they would be under the previous calculation. This will also affect the setting of PRA buffers.

### ***Stress tests in the Internal Capital Adequacy Assessment Process (ICAAP)***

All firms which are within the scope of the CRR are required to conduct stress testing as part of their ICAAP.<sup>9</sup> The PRA has previously set out its expectations for firms' stress test analysis in their ICAAP. This includes the expectation that firms will project their capital resources and capital requirements over a three to five year horizon, taking account of their business plans and the impact of relevant adverse scenarios.<sup>10</sup>

The update to the calculation of risk-weighted hurdle rates for the annual stress test does not affect this expectation. However it may be helpful for firms to consider the new approach when conducting stress tests as part of their ICAAP.

July 2018

---

<sup>8</sup> A PRA buffer may also be set where the PRA assesses a firm's risk management and governance to be significantly weak in order to cover the risks posed by those weaknesses until they are addressed.

<sup>9</sup> As laid out in Internal Capital Adequacy Assessment 12.1 of the PRA Rulebook.

<sup>10</sup> See PRA Supervisory Statement 31/15 'The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)', December 2017: [www.bankofengland.co.uk/prudential-regulation/publication/2013/the-internal-capital-adequacy-assessment-process-and-supervisory-review-ss](http://www.bankofengland.co.uk/prudential-regulation/publication/2013/the-internal-capital-adequacy-assessment-process-and-supervisory-review-ss).