

Statement of Policy

The PRA's approach to the implementation of the systemic risk buffer

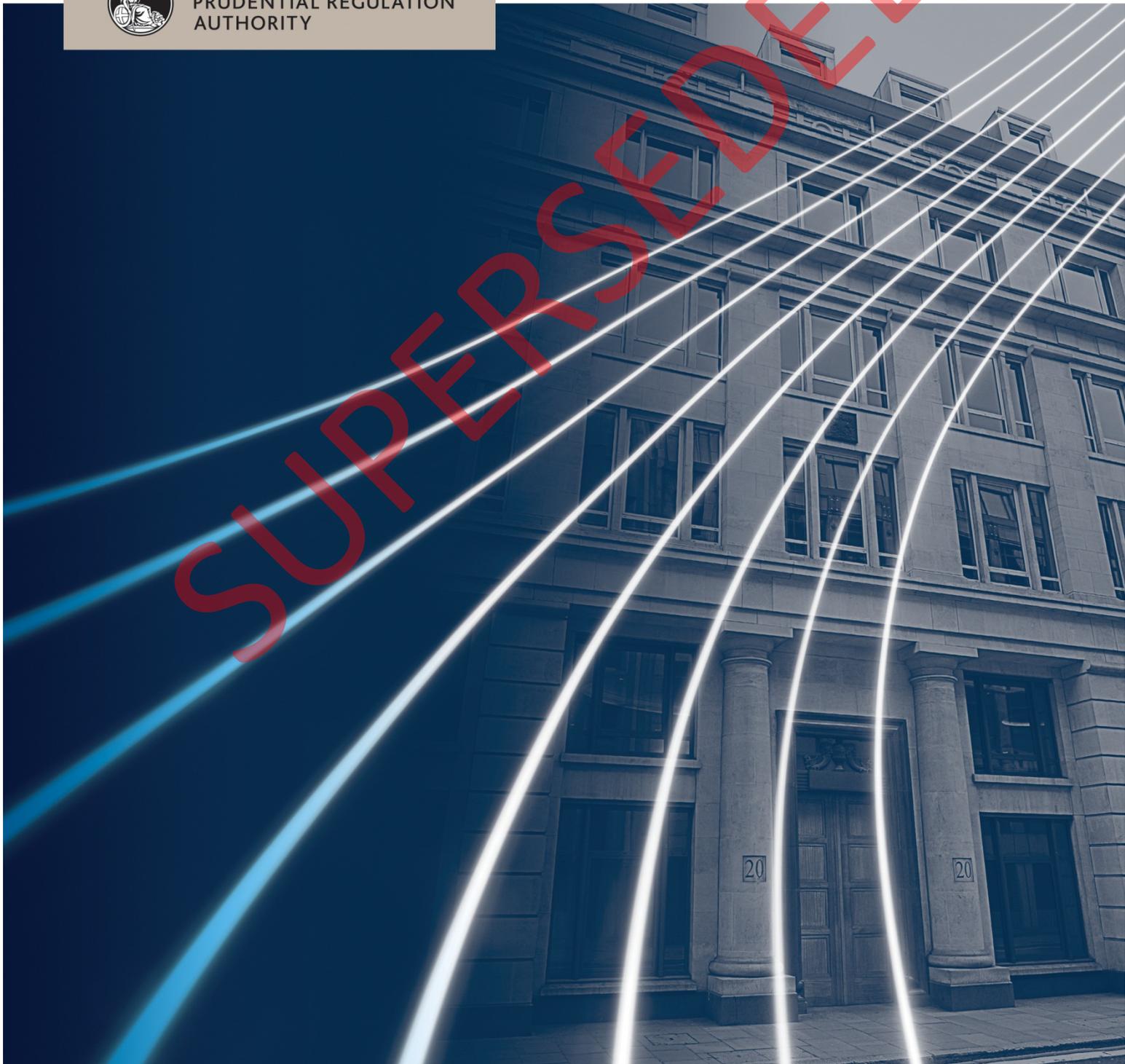
December 2018

(Updating December 2016)



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

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1 Introduction

1.1 This statement of policy (SoP) sets out the Prudential Regulation Authority's (PRA) approach to the implementation of the systemic risk buffer (SRB).

1.2 In line with the Independent Commission on Banking (ICB) recommendations, the UK legislation implementing the SRB requires the Financial Policy Committee (FPC) to establish a framework for an SRB that applies to large building societies and ring-fenced bodies (RFBs). The SRB Regulations¹ require the PRA to apply the framework set out by the FPC on the SRB from 1 January 2019.

1.3 The FPC published 'The Financial Policy Committee's framework for the systemic risk buffer' ('FPC framework') in May 2016.² Alongside the FPC framework, this SoP will form the Bank of England's broader framework for the SRB.

1.4 The PRA will review this SoP at least every two years.

2 Firms in scope of the framework

2.1 This SoP is relevant to RFBs, within the meaning of section 142A of the Financial Services and Markets Act 2000 (FSMA), and large building societies that hold more than £25 billion in deposits (where one or more of the accountholders is a small business) and shares (excluding deferred shares) – jointly 'SRB institutions'.³

3 SRB capital implications

3.1 The SRB is defined in the Capital Requirements Directive (2013/36/EU) as a buffer that can be used to prevent and mitigate long term non-cyclical macroprudential or systemic risks not covered by the Capital Requirements Regulation (EU) 575/2013 (CRR). The SRB can be used where there is a risk of disruption in the financial system with the potential to have serious negative consequences for the financial system and the real economy of a specific Member State.

3.2 The SRB is a firm-specific buffer (ie its amount may vary from firm to firm). It is based on a firm's worldwide risk-weighted exposures and each firm will be required to ensure that it is met solely with Common Equity Tier 1 capital. Where it has decided to impose an SRB on an SRB institution, the PRA will invite that firm to apply for a requirement to be imposed on it under section 55M of FSMA in order to set the SRB. Where firms do not apply, the PRA would consider imposing such a requirement on its own initiative. The requirement would have the effect of increasing the size of the combined buffer a firm must meet to avoid restrictions on distributions. This is in line with the approach taken with regard to the PRA's implementation of the global systemically important institutions (G-SII) buffer, which is also a firm-specific buffer, and is set using the PRA's powers under section 55M FSMA.

1 The Capital Requirements (Capital Buffers and Macro-prudential Measures) (Amendment) Regulations 2015.

2 Available at <https://www.bankofengland.co.uk/paper/2016/the-financial-policy-committees-framework-for-the-systemic-risk-buffer>.

3 For a detailed definition of the institutions in scope see: The Capital Requirements (Capital Buffers and Macro-prudential Measures) (Amendment) Regulations 2015.

3.3 SRB institutions will be prevented from using capital maintained to meet the SRB to meet any other capital requirements or buffers. Where an SRB institution is subject to both a G-SII buffer and an SRB on the same basis of consolidation, the higher of the two shall apply.

3.4 Group risk⁴ may arise when an RFB is subject to an SRB at the level of the RFB sub-group,⁵ but the consolidated group is either not subject to a G-SII buffer, or its G-SII buffer rate is lower than its SRB buffer rate. In May 2016 the FPC recommended to the PRA that it should seek to ensure that, where systemic buffers apply at different levels of consolidation, there is sufficient capital within the consolidated group, and distributed appropriately across it, to address both global systemic risks and domestic systemic risks.⁶

3.5 The PRA amended its Statement of Policy on its methodologies for setting Pillar 2 capital⁷ to take account of this type of group risk when assessing capital adequacy at the consolidated group level under Pillar 2 to ensure that sufficient capital of appropriate quality is held within, and distributed appropriately across, the consolidated group to cover the risks faced by the RFB sub-group itself and, separately, group entities that are not members of the RFB sub-group.

3.6 As indicated in SS45/15 'The UK leverage framework',⁸ SRB institutions subject to an SRB will also be subject to an additional leverage ratio buffer (ALRB) rate. As set out in the June 2018 Financial Stability Report, the FPC intends to review the UK leverage ratio framework once there is clarity on the finalised implementation of the leverage ratio requirement in EU law.⁹

4 Application of the framework in 2019

4.1 The PRA will apply the FPC's framework for the SRB to each SRB institution. As a result of this assessment, some SRB institutions may receive a positive SRB rate while others may receive a zero SRB rate. When applying the framework, the PRA will assign to each SRB institution a systemic score equal to its total assets at the end of the previous calendar year, calculated on the applicable basis of regulatory consolidation.

4.2 As outlined in SS8/16,¹⁰ the applicable basis of consolidation for ring-fenced entities will be the sub-consolidated basis where an RFB sub-group is in place. In cases where an RFB is not a member of an RFB sub-group (ie where the PRA has determined that an RFB should not be required to meet prudential requirements on a sub-consolidated basis), the PRA will consider on a case-by-case basis at which level to apply the FPC framework and set the SRB.

4.3 For building societies in scope of the framework, the applicable basis of calculation will be the consolidated basis for building societies that are the parents of consolidated groups and the individual basis for all others.

4 Group risk, as defined in the PRA Rulebook (Internal Capital Adequacy Assessment 1.2), 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.

5 An RFB sub-group is a subset of related group entities within a consolidated group, consisting of one or more RFBs and other legal entities, which is established when the PRA gives effect to Article 11(5) of the CRR.

6 See Chapter 4 of FPC framework available at <https://www.bankofengland.co.uk/paper/2016/the-financial-policy-committees-framework-for-the-systemic-risk-buffer>.

7 PRA Statement of Policy 'The PRA's methodologies for setting Pillar 2 capital', April 2018, <https://www.bankofengland.co.uk/prudential-regulation/publication/2015/the-pras-methodologies-for-setting-pillar-2-capital>.

8 <https://www.bankofengland.co.uk/prudential-regulation/publication/2015/the-uk-leverage-ratio-framework-ss>.

9 <https://www.bankofengland.co.uk/financial-stability-report/2018/june-2018>.

10 'Ring-fenced bodies (RFBs)', July 2016: <https://www.bankofengland.co.uk/prudential-regulation/publication/2016/ring-fenced-bodies-ss>.

4.4 For each SRB institution, the PRA will derive an SRB rate corresponding to its systemic score. This will be in accordance with the mapping outlined in the FPC framework. Before setting each institution's SRB rate, the PRA may, in the exercise of sound supervisory judgement, deviate from the rate derived from the FPC framework, or waive the requirement and set no buffer rate for the SRB institution.

4.5 The PRA expects that it will exercise supervisory judgement to deviate from the SRB 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.

4.6 When making such decisions, the PRA will have regard to applicable statutory obligations and regulatory principles, including the requirement that the SRB should not entail disproportionate effects on the whole or parts of the financial system of other Member States, or of the European Union as a whole, therefore forming or creating an obstacle to the functioning of the internal market.

4.7 When setting the 2019 SRB rates, the PRA will announce the SRB rate of each SRB institution and the date from which each SRB institution will have to apply the buffer. The PRA expects to announce the first rates in early 2019 and apply them three months after the date of the announcement. The PRA may adapt this timeline, where appropriate, in light of its objectives and statutory responsibilities.

5 Application of the framework following the initial SRB rates

5.1 Following application of the initial SRB rates, the PRA will re-apply the SRB framework annually in the manner outlined in paragraphs 4.1 to 4.6 of this SoP. The PRA expects to announce the SRB rates resulting from its assessment by 15 December of each year and to require institutions to apply them on an ongoing basis by 1 January of the second year following the calendar year when the rates were announced.¹¹ For example, the SRB rates announced in December 2019 would take effect as of 1 January 2021. The PRA may adapt this timeline, where appropriate, in light of its objectives and statutory responsibilities.

6 Recognition of EEA buffer rates

6.1 The PRA notes its responsibility for deciding whether EEA SRB rates should be reciprocated from 1 January 2019.¹² The PRA will make such decisions on a case-by-case basis. When doing so, the PRA will take into account the information set out in the relevant notification submitted by the EEA authority, as well as the materiality and effect of any decision to the UK financial system and PRA regulated firms.

11 This will align the implementation timelines of the SRB with those of the G-SII buffer as outlined in the 'Commission Delegated Regulation (EU) No 1222/2014 with regard to regulatory technical standards for the specification of the methodology for the identification of global systemically important institutions and for the definition of subcategories of global systemically important institutions', <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R1608&from=EN>.

12 'Reciprocated' for these purposes refers to the process of recognition of EEA buffer rates under regulation 34J of the Capital Requirements (Capital Buffers and Macro-prudential Measures) Regulations 2014. Under these regulations, the PRA may not require an SRB institution to apply the EEA buffer rate if it has set an SRB for that institution and the SRB rate is greater than the EEA buffer rate.

Annex Statement of Policy updates

This annex details changes made to this Statement of Policy following its initial publication in December 2016.

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This Statement of Policy was updated in 2018 following the publication of Policy Statement (PS) 32/18 'The systemic risk buffer: Updates to the Statement of Policy'.¹³ It was updated to:

- remove the statement that the PRA's approach to reviewing the SoP every two years is mandated by the SRB regulations;
- replace references to CP25/16 with the corresponding PRA SoP on its methodologies for setting Pillar 2 capital following publication of the final policy;
- include references to Supervisory Statement 45/15 'The UK leverage ratio framework', which was updated in November 2018 with respect to the application of an additional leverage ratio buffer (ALRB) rate to SRB institutions; and
- change footnote 11 (paragraph 5.1) to update references to the Delegated Regulation (EU) No 1222/2014.

This SoP was also updated to simplify the formatting and aid readability, including sequential numbering of footnotes, the updating of hyperlinks to reflect the location of materials on the Bank of England's website, and to make hyperlinks more easily identifiable.

¹³ <https://www.bankofengland.co.uk/prudential-regulation/publication/2018/the-systemic-risk-buffer-updates-to-the-statement-of-policy>.