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PRA Policy Statement 17/15

Assessing capital adequacy under Pillar 2: A Digest

Governance,
Risk,
Compliance &
Assurance
Solutions

Incorporating

(i) Statement of Policy: *The PRA's methodologies for setting Pillar 2 capital*

(ii) Supervisory Statement SS31/15: *The Internal Capital Adequacy Assessment Process and the Supervisory Review and Evaluation Process* as updated

(iii) SS32/15: *Pillar 2 reporting*

August 2015

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Contents

Exec Summary

- **IN**:
  - The PRA Buffer, which can be drawn down in times of stress, but also with potential increments of P1 capital to encourage timely remediation of any perceived shortcomings in risk management and governance
  - The benchmarking of Standardised Approach risk weights to representative internal ratings-based risk weights – a potential minimum P2A add-on
  - A formulaic assessment of credit concentration risk, putting a floor under P2A capital for that risk
  - Separate determinations of conduct operational risk and non-conduct operational risk, the latter based partly on historical loss extrapolation
  - Prescribed stress-testing of obligations under defined benefit pension schemes
- **OUT**:
  - CPB (replaced by the PRA Buffer)
- **STAYING**:
  - Comprehensive internal stress-testing requirements; reverse stress-testing
  - PS7/13 standards for IRRBB
  - Existing market and counterparty credit risk standards
  - CRDIV capital buffers

Impact Analysis

RULE	IMPACT
The PRA Buffer with potential increments	No change in effect: like-for-like replacement of CPB plus options for %age increments and fixed add-ons
Benchmarking Standardised Approach risk weights to IRB risk weights (note netting of gains and losses)	Winners: Exposures to Sovereigns CQS 2-4, Mortgages, Institutions (except CQS 6). Losers: Exposures to Sovereigns CQS 1 & 6, Commercial Real Estate, Credit Cards
Separate determinations of conduct and non-conduct operational risk	A range of regulatory treatment: firms should be proactive and apply appropriate methodologies
Explicit expectations of IRR management via policy, systems and limits for all firms	Some smaller firms may need to review their assessment of, specifically, basis risk, re-pricing and optionality risks
Formulaic assessment of credit concentration risk floor for P2A capital	Smaller firms with concentrated bank counterparty exposures may require special consideration

Governance

- The management body should be able to demonstrate an understanding of the ICAAP consistent with taking responsibility for it

- The appropriate levels of the firm's management should be prepared to discuss and defend all aspects of the ICAAP, covering both quantitative and qualitative components

The PRA Buffer

- The PRA Buffer replaces the Capital Planning Buffer. Like the CPB it will be a usable resource under stress, without sanction providing a remediation path is clear
- The PRA Buffer is a firm-specific measure set on a case-by-case basis; all firms will be subject to a PRA buffer assessment
- Where SREP reviews are planned between August and December 2015, the PRA will discuss with the firm the application of the revised Pillar 2A methodologies. New ICGs will be applicable from 1 January 2016.
- The PRA will write to all firms before 1 January 2016 to convert their existing CPB into a PRA buffer
- By January 2019 the PRA Buffer must be met wholly with CET1; in the meantime
  - 25% by January 2016
  - 50% by January 2017
  - 75% by January 2018
  - The remaining portion can be met with any category of CRR-compliant capital instrument
- Capital used to meet Pillar 1 and Pillar 2A requirements, or to meet CRDIV buffers, cannot be counted to meet any PRA buffer
- The PRA buffer may be incremented in response to perceived weaknesses in risk management and governance

Stress-testing

- A firm should undertake a broad range of stress tests which reflect a variety of perspectives, including sensitivity analysis, scenario analysis and stress testing on individual portfolios as well as at a firm-wide level
- *If a firm is merely attempting to replicate the PRA's own methodologies it will not be carrying out its own assessment in accordance with the ICAA rules*
- *The PRA expects firms to assign adequate resources, including IT systems*, to stress testing and scenario analysis, so as to be able to accommodate different and changing stress tests at an appropriate level of granularity
- For firms not participating in the concurrent stress testing, the PRA publishes a macroeconomic scenario to serve as a guide and, where relevant, as a severity benchmark
- …[but] *all firms should continue to develop their own scenarios* and
- stress tests and scenario analyses that test its business plan to failure
- Stress-testing outcomes must be acted upon through, if appropriate, upward P2A adjustments

IRRBB

- Smaller and less complex firms are subject to a standard approach which is based on reviewing their own policy limits for interest rate risk and, where appropriate, basis risk
- Firms' systems and processes should allow measurement of the sensitivity of its activities to, if material, re-pricing risk…and risks arising from embedded optionality (e.g. pipeline risk and prepayment risk) as well as changes in assumptions (e.g. those relating to customer behaviour)
- the PRA expects that a bank or building society mitigates its basis risk by setting limits on:
  - its exposure to basis risk for each type of basis risk mismatch; and
  - the sensitivity of its net interest margin to basis risk

IRB Benchmarking

- Supervisory judgement is used to determine the credit risk add-on
- Benchmarks have been calculated for *mortgages, credit cards, corporates, sovereigns and institutions* (the latter mapped to credit quality steps)
- If one or more benchmark implies that the Standardised Approach Pillar 1 capital charge overestimates the levels of capital required, the excess can be used to reduce or remove shortfalls against other benchmarks which would otherwise result in P2A add-ons.
  - Winners - Exposures to: Sovereigns CQSs 2-4, Mortgages, Institutions (except CQS 6)
  - Losers - Exposures to: Sovereigns CQSs 1 & 6, Commercial Real Estate, Credit Cards

- Firms are required to calculate a credit concentration risk measure, the HHI*, for all relevant portfolios (single name, pre-defined industry sectors and geographic regions)
- The HHI is defined as the sum of the squares of the relative portfolio shares of all borrowers' RWAs
- *Well-diversified portfolios have an HHI close to 0, whilst the most concentrated portfolios have a number close to 1*
- Mapping models translate a firm's HHI into a capital add-on range for relevant portfolios, which could be as low as 0% of RWAs or as high as 8.2% across all 3 of single-name, sector and geographic concentration risks
- *A potential floor (but not a ceiling!) under P2A add-ons for this risk*

*The Herfindahl-Hirschman Index

Operational Risk P2A Capital

- The approach applies to all PRA Category 1 firms but may be extended to other firms
- In determining whether to use the methodology for non-Category 1 firms, the PRA takes into account the size and complexity of a firm
- Where the PRA decides not to use the full methodology, it assesses operational risk on the basis of data provided by the firm, the firm's own assessment of operational risk and supervisory judgement.
  - *The determination of additional P2A capital for conduct risk is driven by supervisory judgement*
  - The PRA *may* use three loss estimates to inform the capital requirement for non-conduct risk:
    - C1 - a firm's forecast of its expected losses, extrapolated to the 1/1,000 year confidence level
    - C2 - based on the average of the firm's five largest losses by Basel event type (excluding conduct) for each of the past five years at a 1/1,000 year confidence level
    - C3 - uses a firm's scenario assessments excluding conduct scenarios…to fit a calibration-free, fat-tailed distribution to determine the annual impact at a 1/1,000 year confidence level. The C3 estimate is obtained by summing the five largest annual impacts, to which a predefined diversification benefit is applied.
- Business continuity plans are also a key component of operational risk management

Pension Obligation Risk

- Pension obligation risk relates to defined benefit schemes that are not fully matched by underlying investments
- Under CRD IV, the accounting deficit of a firm's pension scheme is deducted from CET1
- The PRA's framework for Pillar 2A pension obligation risk capital consists of two elements:
  - the firm's own assessment of the appropriate level of Pillar 2A pension obligation risk capital; and
  - a set of stresses on the accounting basis which will be used by the PRA in assessing the adequacy of the firm's own assessment of the level of capital required

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- All firms must submit with the ICAAP, and more frequently if required:
  - FSA071 - Firm information and P2 summary assessment
  - FSA078 - Pillar 2 Concentration Minimum data requirements
  - FSA079 - Pillar 2 Concentration Additional data requirements

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FSA071

Reporting date and firm identifier

	FRN:	
Pillar 2 data	Reporting date:	
	Reporting Currency	
Name	Tel Number	E-mail
1	Previous ID:	
annual	Version No:	1.0
Pillar 1, Currency (firms can provide this information at the ICAAP reference date to facilitate PRA review)	P2, Currency	Comments

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FSA078-FSA079 G

Template FSA078 - Pillar 2 Concentration Minimum data requirements & Template FSA079 - I

Section 1: Firm minimum data requirements (FSA078)

1. For the assessment of single name, sector and geographic (international) concentration risk firms the portfolios within scope (see Section 2) for each of the concentration risk types. RWAs should be cal Requirement (CRR), i.e. Standardised, Foundation IRB or Advanced IRB. For Counterparty Credit Risk should be excluded from the RWA estimate. For Central Counterparty (CCP) exposures the Default Fu
2. The HHI is calculated as:

$$HHI = \frac{\sum w(i)^2}{(\sum w(i))^2}$$

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KnowCo is a specialist UK-bank support resource for:

- ICAAP
- ILAAP
- Risk Appetite Statement development and enhancement
- RRP
- Regulatory Disclosure
- Business Planning and Modelling and
- Risk Management Policies, Processes and Assurance

Our intuitive and transparent ALM software facilitates compliance with regulatory requirements for:

- Credit risk capital (Pillars 1 and 2) stress-testing and management
- IRRBB stress-testing and management
- Liquidity risk stress-testing and management
- Funds Transfer Pricing and
- Strategic business modelling
- Metrics such as LCR and HHI

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Please contact

- Paul Ashton at paul.ashton@knowco.co.uk, or
- Dr. Lise Land at lise.land@knowco.co.uk, or
- visit www.knowco.co.uk or call +44 (0)7799 113535