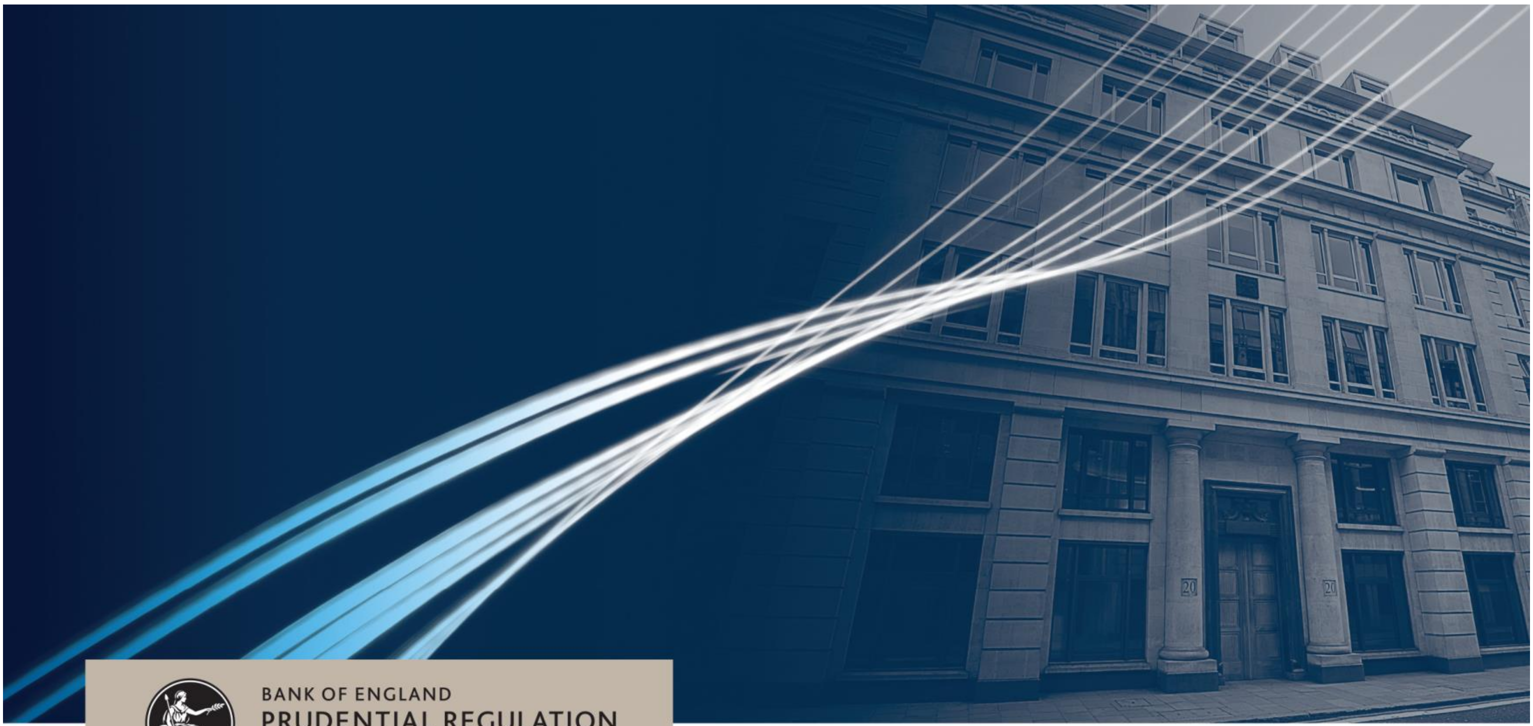

BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Consultation Paper | CP27/16

The PRA's implementation of the systemic risk buffer

July 2016

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Responses are requested by Friday 28 October 2016.

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Contents

1 Overview

1.1 In this consultation paper (CP) the Prudential Regulation Authority (PRA) proposes a draft statement of policy (SoP) setting out the PRA's approach to the implementation of the systemic risk buffer (SRB).

1.2 The CP is relevant to ring-fenced bodies 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'.[1]

Background

1.3 The UK economy depends on the critical financial services provided by financial institutions, in particular large banks and building societies. The crisis was an example of how the economy can be damaged when such firms become distressed and restrict lending. It is therefore important that such institutions carry higher levels of capital so that they can absorb stresses and continue to maintain critical financial services to the real economy, particularly the provision of credit. This principle has been recognised in the Basel framework for global systemically important banks which has been implemented through European legislation and subsequent changes to UK legislation.

1.4 The Basel and European frameworks also recognise that banks can be systemically important in a domestic context and could therefore warrant higher capital requirements to be available to absorb stress. The UK Independent Commission on Banking (ICB) recommendations proposed that UK systemically important ring-fenced bodies (RFBs) and building societies be held to a higher capital standard.

1.5 In line with the 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 RFBs. The SRB Regulations[2] require the FPC to specify a set of criteria for assessing the extent to which the failure or distress of an SRB institution might pose a long term non-cyclical systemic or macroprudential risk (which is specified as meaning a risk of disruption to the financial system with the potential to have serious negative consequences for the financial system and the real economy in the United Kingdom). They also require the FPC to create a methodology for measuring the criteria and giving SRB institutions a single score in relation to the criteria with a corresponding SRB rate.

1.6 Under the SRB Regulations the PRA must apply the FPC's framework as of 1 January 2019. When doing so the PRA is required to decide:

(i) whether, in the exercise of sound supervisory judgement, to deviate from the SRB rates derived from the FPC framework or waive the requirement and set no buffer rate for the SRB institution;

(ii) the basis of consolidation on which to apply the framework to an SRB institution (individual, sub-consolidated or consolidated); and

(iii) the frequency of, and timelines for, the application of the framework and rates.

1 For the full definition of the institutions in scope see: The Capital Requirements (Capital Buffers and Macro-prudential Measures) (Amendment) Regulations 2015 (SI 2015/19).

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

1.7 The FPC set out its framework for the SRB in May 2016 ('FPC framework').[1] The draft SoP in this CP outlines the PRA's proposed approach to the application of the FPC framework.

1.8 The policy contained in this CP 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 those arising once any new arrangements with the European Union take effect.

Summary of proposals

1.9 The four policy proposals included in this CP are:

(i) the PRA expects that it will, in the exercise of sound supervisory judgement, deviate from the SRB rates derived from the FPC framework only in exceptional cases;

(ii) for building societies in scope of the framework, the applicable basis of the framework will be the group consolidated basis for building societies that are the parents of consolidation groups and the individual basis for all others;

(iii) the initial SRB rates will be set and announced by the PRA in early 2019 and will apply three months after being set; and

(iv) following the application of the initial SRB rates, rates will be set and announced annually and will apply the second year following the calendar year of the year they were set.

Responses and next steps

1.10 This consultation closes on Friday 28 October 2016. The PRA invites feedback on the proposals set out in this consultation. Please address any comments or enquiries to CP27_16@bankofengland.co.uk.

2 Proposals

2.1 The PRA's proposed SoP outlines the firms in scope of the framework, the capital implications of the SRB, and the PRA's approach to applying the SRB framework. The sections outlining the PRA's application of the framework include proposals on four issues the PRA is required to decide on:

(i) what factors may warrant the PRA to exercise sound supervisory judgement to deviate from the SRB rates derived from the FPC framework;

(ii) the basis of application of the SRB to building societies;[2]

(iii) when to set and apply the initial SRB rates; and

(iv) when to set and apply SRB rates following the application of the initial rates.

1 'The Financial Policy Committee's framework for the systemic risk buffer', May 2016; www.bankofengland.co.uk/financialstability/Pages/fpc/systemicrisk.aspx.

2 The basis of application of the SRB on RFBs is outlined in PRA Policy Statement 20/16 'The implementation of ring-fencing: prudential requirements, intra-group arrangements and use of financial market infrastructures', July 2016; www.bankofengland.co.uk/pra/Pages/publications/ps/2016/ps2016.aspx.

Exercising 'sound supervisory judgement' to deviate from the SRB rates derived from the FPC framework

2.2 The PRA may, in the exercise of sound supervisory judgement, deviate from the SRB rates derived under the FPC framework or waive the requirement and set no buffer rate for the SRB institution. The PRA proposes that it expects to do so only in exceptional cases, with the expectation that these will 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 proven actions by a firm to deliberately 'game' the framework such that its systemic score underestimates its true systemic importance.

2.3 The FPC framework is designed to measure an SRB institution's systemic importance and to map it to a commensurate SRB rate that will mitigate long term non-cyclical systemic or macroprudential risks. Ensuring the intended application and outcomes of this framework is in accordance with the PRA's statutory responsibilities.

Scope of application of the SRB for building societies

2.4 The SRB may apply on an individual, sub-consolidated, or consolidated basis. In July 2016, the PRA outlined its approach to setting the SRB rate for an RFB on a sub-consolidated basis where an RFB group is in place, and making a decision on a case-by-case basis where the PRA has determined that an RFB should not be required to meet prudential requirements on a sub-consolidated basis.[1]

2.5 The PRA proposes that for building societies that are parent institutions and subject to consolidated supervision the SRB will apply on the group consolidated basis. For building societies that are not subject to consolidated supervision as groups, the SRB will apply on the individual basis.

2.6 The proposed approach is in line with the policy aim of the SRB to increase the resilience of material providers of lending to households and non-financial corporates. Building society legislation largely limits the assets of building societies to household and corporate lending. If the SRB were applied on an individual basis to a building society that is the parent of a consolidation group, only a subset of the group's household and corporate lending in the UK would be captured within the framework. This would result in an inaccurate measurement of the group's systemic importance.

Setting and applying the initial SRB rates

2.7 The PRA proposes to set and announce the initial rates in early 2019 and apply them three months after the date of the announcement. It proposes to maintain its flexibility to adapt this timeline as more information on firms' ring-fenced entities becomes available.

2.8 The PRA's statutory powers over the SRB apply from 1 January 2019, together with the effective date of ring-fencing reforms. The PRA believes that the SRB should be applied as quickly as possible after this date to ensure that the SRB institutions' resilience to stresses is commensurate to their systemic importance to the UK economy. Following publication of the final SoP, SRB institutions will have all the necessary information to estimate their initial SRB rate. For this reason, the PRA believes that a three-month period is sufficient time for firms to adjust to the initial rates.

1 See PS20/16 (ibid footnote 1, page 7).

Setting and applying SRB rates following the application of the initial rates

2.9 Following application of the initial SRB rates, the PRA proposes to align the timeline for setting and applying SRB rates with that of the global systemically important institutions (G-SII) buffer, where rates are decided by the PRA by 15 December of each year and take effect as of 1 January of the second year following the calendar year of the year the rates were set.[1] For example, the rates announced in December 2019 will take effect as of 1 January 2021. The PRA proposes to maintain its flexibility to adapt this timeline under exceptional circumstances and in order to meet its objectives.

2.10 The PRA must review any decision it makes when applying the SRB framework, and set SRB rates at least once every second year. Aligning the timeline of the SRB framework with that of the G-SII buffer will allow the PRA to conduct a comprehensive assessment of an institution's systemic importance, covering risks to both the global and domestic economies. An annual assessment that follows the financial year of most firms will also facilitate firms' capital planning and their ability to make any necessary capital adjustments without deleveraging.

3 The PRA's statutory obligations

3.1 The proposals in this CP are compatible with the PRA's statutory obligations under FSMA.[2] The SRB is intended to increase the capacity of UK domestic systemically important RFBs and building societies to absorb stresses, thereby increasing their resilience relative to the system as a whole and promoting the safety and soundness of PRA regulated firms.

3.2 The PRA concludes that the proposals in this CP also facilitate effective competition. To the extent that the SRB helps alleviate the funding advantages that SRB institutions enjoy through rating agencies' credit rating uplifts, it will help level the playing field and lessen barriers to effective competition.

Cost benefit analysis

3.3 The costs and benefits of the SRB were assessed and outlined in the FPC framework for the SRB.[3] The PRA's proposals in this CP are consistent with the assumptions that were used in that analysis. The PRA agrees with the FPC's conclusion that the SRB is estimated to produce net benefits of around 0.6%-0.8% of GDP by increasing the resilience of SRB institutions and thereby reducing the likelihood that they will curtail lending.

Regulatory principles

3.4 In developing the proposals in this CP, the PRA has had regard to the regulatory principles. Three of the principles are of particular relevance:

(i) the desirability of sustainable economic growth;

(ii) proportionality; and

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1 See: Commission Delegated Regulation (EU) No 1222/2014 of 8 October 2014 supplementing Directive 2013/36/EU of the European Parliament and of the Council 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 Text with EEA relevance; http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32014R1222.

2 Section 138J of FSMA.

3 Ibid footnote 1, page 6.

(iii) public disclosure.

3.5 Increasing the resilience of SRB institutions that are systemic to the UK economy will reduce the likelihood that they will curtail lending in distress. Reducing the likelihood of disruption to lending supply will help promote medium to long-term sustainable growth by reducing the probability of crises and leading to higher levels of expected future output than would be the case without the SRB.

3.6 By ensuring that SRB rates are commensurate to SRB institutions' systemic importance, the capital buffer applied to each institution will be proportionate to the benefits of addressing the systemic risk posed by the institutions to the UK economy.

3.7 Where the PRA sets an SRB rate, the PRA intends to publish all decisions it has made in applying the rate, including the buffer rate itself and its justification for setting the rate.

Impact on mutuals

3.8 In the PRA's opinion, the impact of the proposed SoP on mutuals is expected to be no different from the impact on RFBs.

Equality and diversity

3.9 The PRA has performed an assessment of the policy proposals and does not consider that the proposals give rise to equality and diversity implications.

Appendix – Draft statement of policy 'The PRA's implementation of the systemic risk buffer'

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 Regulations[1] require the PRA to apply the framework set out by the FPC on the SRB from 1 January 2019.

1.3 The FPC set out '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's broader framework for the SRB.

1.4 The PRA will review this SoP in 2018, following the review of the FPC framework. Should the FPC framework be reviewed before that, the PRA will bring forward the review of this SoP accordingly.

2 Firms in scope of the framework

2.1 This SoP is relevant to ring-fenced bodies, within the meaning of section 142A of FSMA(c), 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. It is based on firms' risk-weighted exposures located anywhere in the world and firms will be required to ensure that it is made up of Common Equity Tier 1 capital. Where applicable to a firm, the SRB will be set by the PRA using its powers under section 55M of the Financial Services and Markets Act (2000), which will 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 PRA's implementation of the global systemically important institutions (G-SII) buffer, which also addresses elements of systemic risk in the form of a separate firm-specific buffer.

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.

1 The Capital Requirements (Capital Buffers and Macro-prudential Measures) (Amendment) Regulations 2015.
2 Available at www.bankofengland.co.uk/financialstability/Pages/fpc/systemicrisk.aspx.
3 For a detailed definition of the institutions in scope see: The Capital Requirements (Capital Buffers and Macro-prudential Measures) (Amendment) Regulations 2015.

3.4 Group risk[1] may arise when an RFB is subject to an SRB at the level of the RFB sub-group,[2] but the consolidated group is either not subject to a G-SII buffer, or its G-SII buffer rate is lower than its SRB 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.[3]

3.5 In July 2016, the PRA proposed in Consultation Paper 25/16[4] 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 the FPC leverage ratio policy statement and the FPC's SRB framework, SRB institutions subject to an SRB would also be subject to an additional leverage ratio buffer (ALRB) rate, calculated at 35% of the SRB rate.[5]

4 Application of the framework in 2019

4.1 The PRA will apply the FPC 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 Policy Statement 20/16,[6] 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 rate.

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.

4.4 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.

1 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.
2 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 Capital Requirements Regulation (CRR).
3 See: Chapter 4 of FPC framework available at www.bankofengland.co.uk/financialstability/Pages/fpc/systemicrisk.aspx.
4 'The implementation of ring-fencing: reporting and residual matters'; www.bankofengland.co.uk/pra/Pages/publications/cp/2016/cp2516.aspx.
5 FPC, 'The Financial Policy Committee's review of the leverage ratio', October 2014; www.bankofengland.co.uk/financialstability/Documents/fpc/fs_lrr.pdf.
6 'The implementation of ring-fencing: prudential requirements, intra-group arrangements and use of financial market infrastructures', July 2016; www.bankofengland.co.uk/pra/Pages/publications/ps/2016/ps2016.aspx.

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 proven actions by a firm to deliberately manipulate its systemic score so that the framework underestimates its systemic importance.

4.6 When making such decisions, the PRA will have regard to the applicable statutory obligations and regulatory principles. The PRA will also seek to ensure that the SRB does not create an obstacle to the functioning of the internal market or generate disproportionate effects on the whole or parts of the financial system of other Member States, or of the European Union as a whole.

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 in order to meet 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 on-going basis by 1 January of the second year following the calendar year when the rates were announced.[1] For example, the SRB rates announced in December 2019 will take effect as of 1 January 2021. The PRA may adapt this timeline in order to meet 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.[2] 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.

1 This will align the implementation timelines of the SRB with those of the G-SII buffer as outlined in: EBA, 'FINAL draft Regulatory Technical Standards on the methodology for the identification of global systemically important institutions (G-SIIs) under Article 131 of Directive 2013/36/EU', June 2014, EBA/RTS/2014/07; www.eba.europa.eu/documents/10180/717782/EBA-RTS-2014-07+(Final+Draft+RTS+on+G-SII+identification).pdf.

2 "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.