3: Draft amendments to new draft statement of policy – The PRA's methodologies for setting Pillar 2 capital for Small Domestic Deposit Takers (SDDTs)

In this appendix, new text is underlined and deleted text is struck through.

6 Pension obligation risk

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Definition and scope of application

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6.5 Pension obligation risk manifests itself in different forms. The PRA's focus is on the impact that changes in <u>the</u> value of a pension scheme could have on Common Equity Tier 1 (CET1). The accounting deficit of an SDDT's pension scheme is reflected in CET1. Under Article 36(1)(e) of the Own Funds and Eligible Liabilities (CRR) Part of the PRA Rulebook, any surpluses are deducted. <u>SDDTs</u>~~Firms~~ are therefore exposed to pension obligation risk because a material increase in the pension scheme's deficit under adverse conditions will have a negative impact on their CET1.

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Methodology for assessing Pillar 2A capital for pension obligation risk

6.8 The PRA's framework for Pillar 2A pension obligation risk capital consists of two elements:

- the SDDT's own assessment of the appropriate level of Pillar 2A pension obligation risk capital; and
- <u>the PRA's review</u> ~~a set of stresses on the accounting basis which will be used by the PRA in assessing the adequacy~~ of the SDDT's own assessment<u>.</u> ~~of the level of capital required.~~

6.9 <u>[Deleted]</u> ~~The SDDT's own assessment and the PRA stress tests on the accounting basis can be reduced by offsets and management actions, and any pension scheme deficit deducted from CET1.~~

6.10 The PRA<u>'s review</u> uses <u>an approach which corresponds to the value at risk of the accounting surplus or deficit consistent with a stress event that has no more than a 1 in 200 probability of occurring in a one-year period. This includes consideration of various factors including equity, credit, interest, inflation, and longevity risks.</u> ~~the results of two scenarios it prescribes to assess the adequacy of the SDDT's own assessment of the appropriate level of~~

~~capital and to inform the setting of the Pillar 2A capital requirement for pension obligation risk. The higher of the two stress scenarios will form the starting point of the assessment.~~

6.11 [Deleted] ~~The two scenarios are set out in **Table 2**.~~

~~**Table 2 PRA pension obligation risk stress scenarios**~~

~~**Per cent**~~	~~Scenario 1~~	~~Scenario 2~~
~~Fall in equity values~~	~~15~~	~~30~~
~~Fall in property values~~	~~10~~	~~20~~
~~Percentage reduction in long-term interest rates~~	~~10~~	~~15~~
~~Absolute increase in assumed inflation~~	~~0.5~~	~~0.75~~
~~Percentage change in credit spreads~~	~~-25~~	~~+25~~
~~Increase in liabilities due to a longevity stress~~	~~3~~	~~6~~

6.12 [Deleted] ~~The PRA recognises that the assumptions underpinning the stress scenarios may not be appropriate for the risk profile of all pension schemes. Where the PRA believes that the risk profile of an SDDT's pension scheme deviates significantly from the assumptions underlying the published scenarios, it will use other models to inform the appropriate level of Pillar 2A pension obligation risk capital to compare against the SDDT's own assessment.~~

6.13 ~~For the purposes of the stress scenarios, the PRA expects the valuation measure of liabilities to be the same as that used for IFRS reporting.~~ SDDTs' approaches to setting the valuation assumptions should be stable over time and any changes to the approach should be justified in the ICAAP. The PRA will review the robustness of the valuation assumptions and may adjust the surplus or deficit in the capital requirements calculations where the assumptions are found to be out of line with other firms, or where an alternative set of assumptions better satisfies the capital adequacy rules.

6.14 [Deleted] ~~The stress scenarios have been designed to produce an appropriate level of capital for a typical pension scheme. From time to time, it may be necessary to update the scenarios to ensure that they continue to remain appropriate. This may be done, for instance, where significant movements in market conditions mean that the scenarios produce inappropriate levels of capital or where the average risk profile of the pension schemes sponsored by PRA-regulated SDDTs deviates from the risk profile the PRA has assumed when calibrating the stress scenarios.~~

6.15 [Deleted] ~~The scenarios described in Table 2 are distinct from the multi-year firm-wide scenarios the PRA expects SDDTs to develop in their ICAAP in accordance with the general stress test and scenario analysis.~~[7]

6.16 [Deleted] ~~The PRA reviews the scenarios on an annual basis, but only expects to make changes to them every few years. Any changes will be consulted on before being implemented.~~

Offsets and management actions

6.17 ~~The SDDT's own assessment of the appropriate level of capital and the results of the PRA stress scenarios may be reduced by eligible offsets and management actions recognised by the PRA.~~ Offsets are reductions in an SDDT's Pillar 2A capital requirement to reflect factors present at the ICAAP effective date which would reduce the impact of a stress on the SDDT. Management actions are steps the SDDT could, and would, take when a stress occurs in order to reduce its impact. The PRA will review the SDDT's offsets and management actions and will adjust them, if necessary, when determining the PRA's view of the capital required.

6.18 The PRA will apply the following criteria in deciding whether to ~~To be~~ accept ~~ed by the PRA,~~ offsets and management actions: ~~in relation to the PRA stress scenarios should comply with the following eligibility criteria:~~

- financial performance — the efficacy of offsets and management actions should not depend on assumptions as to the future financial performance of the SDDT, either before or after a stress;

- independence from the decisions and actions of third parties — the efficacy of offsets and management actions should not depend on assumptions as to the future agreement or behaviour of third parties, either before or after a stress; and

- immediacy — recognised offsets should reflect a risk mitigation benefit that is already effective when the offset is taken. Management actions should be capable of taking effect quickly enough to mitigate the stress to which they are the proposed response.

6.19 ~~The PRA expects SDDTs to explain any offsets or management actions they propose. Where practical, management actions will be formulated after discussion with pension scheme trustees.~~ The PRA will apply the eligibility criteria in a strict manner on a case-by-case basis. Offsets and management actions that do not meet the eligibility criteria will not be accepted.

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11 The Single Capital Buffer

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Reporting

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[7] ~~Rule 12.1 in Internal Capital Adequacy Assessment Part of the PRA Rulebook: https://www.prarulebook.co.uk/pra-rules/internal-capital-adequacy-assessment.~~

11.47 All SDDTs with total assets equal to or greater than £5 billion, at the relevant level of consolidation used as the basis of their ICAAP, must report the data in the stress testing Pillar 2 data item (PRA111) in accordance with Reporting Pillar 2. SDDTs are required to submit the data with their ICAAP submissions. SDDTs with total assets less than £5 billion may be requested by supervisors to complete PRA111 on a case-by-case basis. The information in PRA111 includes information on SDDTs' base and stress scenario projections used in the ICAAP. PRA111 is aligned to the STDF used in the Bank Capital ~~'s annual~~ ~~s~~Stress ~~t~~Test with reduced granularity.

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