4: Draft amendments to SS31/15 – The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)

In this appendix, new text is underlined and deleted text is struck through. This document also incorporates draft amendments proposed under separate consultation papers (CP7/24 – The Strong and Simple Framework: The simplified capital regime for Small Domestic Deposit Takers (SDDTs) and CP9/24 – Streamlining the Pillar 2A capital framework and the capital communications process) which have not been finalised as at the publication date of CP12/25. These draft amendments are highlighted in grey and are not within the scope of consultation for CP12/25.

1 Introduction

1.1 This supervisory statement is relevant to all PRA-regulated banks, building societies, designated investment firms and all PRA-approved or PRA-designated holding companies, except Small Domestic Deposit Takers (SDDTs) and SDDT consolidation entities.[1] SDDTs should refer instead to the draft supervisory statement (SS) – The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP) for Small Domestic Deposit Takers (SDDTs).[2] This SS~~and~~ replaces PRA Supervisory Statement (SS) 5/13[3] and SS6/13.[4] ~~[5]~~

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1.3 Chapter 2: 'Expectations of firms undertaking an ICAAP' sets out the expectations the PRA has in relation to the ICAAP and the requirements set out in the Internal Capital Adequacy Assessment (ICAA) Part of the PRA Rulebook. It sets out the PRA's expectations regarding firms' coverage and treatment of credit risk, interest rate risk in the non-trading book (more commonly referred to as interest rate risk in the banking book or IRRBB), market risk, group risk, operational risk, pension obligation risk and foreign currency lending to unhedged retail and SME borrowers. It also provides additional detail on data that firms are required or expected to submit with their ICAAP document or otherwise as applicable.

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Credit risk

2.6ZA1 The PRA expects firms to use credit scenarios to provide a detailed assessment in their ICAAP document of the capital needed to support their credit risk exposures. When conducting this assessment, a

1 The full definition of an SDDT and an SDDT consolidation entity, including the SDDT and SDDT consolidation entity criteria, are set out in the SDDT Regime – General Application Part of the PRA Rulebook.

2 September 2024: https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2024/september/cp724app6.pdf.

3 PRA Supervisory Statement 5/13, 'The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)'~~, December 2013~~: https://www.bankofengland.co.uk/prudential-regulation/publication/2013/the-internal-capital-adequacy-assessment-process-and-supervisory-review-ss.

4 PRA Supervisory Statement 6/13, 'Stress testing, scenario analysis and capital planning'~~, December 2013~~: https://www.bankofengland.co.uk/prudential-regulation/publication/2013/the-internal-capital-adequacy-assessment-process-and-supervisory-review-ss.

~~5 On 1 February 2017, this SS was updated – see annex for full details.~~

firm should assess whether the capital held against its credit exposures under Pillar 1 is sufficient and whether a Pillar 2A credit risk add-on is necessary.

2.6ZA2 The PRA has set out the general approach it takes to setting Pillar 2A add-ons for credit risk in the statement of policy (SoP) – The PRA's methodologies for setting Pillar 2 capital. While the PRA anticipates that the expectations set out this section will help firms produce an ICAAP document which meets the PRA's expectations, it does not constitute an exhaustive account of everything which a firm must do to satisfy themselves that they are adequately capitalised for credit risk in accordance with the PRA's ICAA rules. Firms remain responsible for considering how best to assess the adequacy of their own capital and should undertake any analysis they deem necessary to ensure they have assessed the major credit risks to which they are exposed.

Credit scenarios

2.6ZA3 The PRA expects firms to design their own scenarios with particular focus on how these events may result in credit losses that are not captured under Pillar 1 or the systematic methodologies (as set out in Chapter 2 of the 'The PRA's methodologies for setting Pillar 2 capital').[8a] This assessment should be used to ensure that minimum requirements across Pillar 1 and Pillar 2A provide sufficient capacity to absorb losses incurred in high-severity tail events over a 12-month horizon. This is more severe than – and different from – the assessment in Pillar 2B, which is intended to ensure that firms maintain sufficient capital to withstand a severe but plausible stress over a longer time horizon and maintain minimum capital requirements. Nevertheless, the Pillar 2B indicators should be used as a guide to the minimum appropriate severity of credit scenarios.

2.6ZA4 A firm should conduct credit scenario analysis on all material SA portfolios, including off-balance sheet exposures and exposures subject to the systematic methodologies. Firms with internal ratings based (IRB) permissions should also conduct credit scenarios on material portfolios risk-weighted under the SA.[8b] Firms should tailor their credit scenarios to reflect their specific credit exposures and portfolio characteristics.

2.6ZA5 The PRA expects firms to detail their credit scenario analysis in their ICAAP, including a clear description of the following:

- the type, characteristics, and severity of stress that its credit portfolio is vulnerable to;
- a brief summary of each material credit portfolio the firm holds, including characteristics and values (eg exposure level, risk weighted assets (RWAs), defaulted vs non-defaulted), and the way in which each of these credit portfolios may be impacted by the range of macroeconomic variables set out in the scenario; and;
- the steps taken to derive the credit loss from the scenarios analysis figures presented.

2.6ZA6 Firms should ensure their own Pillar 2A credit scenarios are more severe than the Bank Capital Stress Tests or equivalent benchmark scenarios published by the PRA.[8c] Firms should use the historical average peak-to-trough change in key macroeconomic scenario variables as a guide to minimum appropriate credit scenario severity, such that the severity of firms' Pillar 2A credit scenarios do not depend on the point in the economic cycle (or reflect specific features of an individual stress scenario that are not necessarily relevant to a Pillar 2A credit scenario). This is without prejudice to the expectation that firms tailor the scenarios to the type of stress that the credit portfolio is vulnerable to and ensure that each scenario is coherent as a whole.[8d]

8a https://www.bankofengland.co.uk/prudential-regulation/publication/2015/the-pras-methodologies-for-setting-pillar-2-capital.

8b For the avoidance of doubt, exposures modelled under the IRB approach are not in scope. This includes exposures risk-weighted under the SA when a firm becomes bound by the output floor.

8c Including Annual Cyclical Scenarios published prior to the introduction of the Bank Capital Stress Test in 2025.

8d For example, firms need to make a judgement on which sort of interest rate scenario to use, reflecting their understanding of how their portfolios are impacted by changes in rates.

2.6ZA7 The PRA expects that the product of firms' credit scenario analysis will be a whole balance sheet assessment of capital adequacy for their exposures on the SA in terms of credit risk. Other risks capitalised in P2A will still be capitalised separately. In assessing whether the credit risk exposures are adequately capitalised, the PRA expects firms to robustly substantiate the idiosyncratic factors in portfolios which they consider to result in any undercapitalisation and/or excess conservatism in Pillar 1.

2.6ZA8 The PRA does not expect firms to undertake credit scenario analysis for portfolios which are immaterial. In these cases, the PRA considers that firms may assume that the Pillar 1 risk weights are sufficient to absorb losses for these exposures. Firms should include information on the portfolios considered immaterial, and the rationale for excluding these from credit scenario analysis, in the ICAAP document. Firms should not artificially subdivide their book into a high number of parts such that they are individually immaterial but collectively material.

Alternative methodologies to assess idiosyncratic credit risk[8e]

2.6ZA9 As an alternative to using credit scenario analysis, firms may use alternative approaches in the ICAAP to inform the assessment of whether they are adequately capitalised against credit risk. These may include assessments using proxy IRB approaches (including proxy models of IRB parameters and proxy slotting approaches as applicable).

2.6ZA10 If a firm uses a proxy IRB approach instead of a credit scenario in its ICAAP, sufficient details should be provided to enable the modelling and assumptions to be understood by the PRA. The PRA also expects firms to take responsibility to ensure any models used to assess capital requirements are robust and comprehensive.

Credit risk mitigation: guarantees and credit derivatives qualifying as unfunded credit protection

2.6A For firms using the Risk Weight Substitution Method or the Parameter Substitution Method, the Credit Risk Mitigation (CRR) Part of the PRA Rulebook ~~Standardised Approach for credit risk, CRR Article 235(1)~~ allows firms to recognise guarantees or credit derivatives qualifying as unfunded credit protection. ~~under Part Three, Title II, Chapter 4 (Credit risk mitigation) of the CRR by substituting the risk weight of an obligor with the risk weight of a guarantor, for the protected amount of the exposure.~~ Firms are expected to assess whether there are any residual risks and evidence this assessment within the ICAAP document. ~~a full substitution of the risk weight of the guarantor is warranted or not.~~ As part of this assessment, firms should consider the risk that, notwithstanding fulfilment of eligibility criteria under Pillar 1 for qualifying guarantees or credit derivatives, the credit protection could in practice become ineffective due to any reason other than the default of the protection provider. ~~guarantor and evidence this assessment within its ICAAP document.~~ As part of this ~~consideration~~, the PRA expects firms to consider ~~in particular~~ the:

- risk, if any, that in practice the protection provider ~~guarantor~~ would seek to reduce or be released from liability under the credit protection ~~guarantee~~, for example through lengthy settlement or disputes processes; and

- operational risk that the firm may breach its obligations under the terms of the credit protection ~~guarantee~~ in a manner that might entitle the protection provider ~~guarantor~~ not to pay out.

2.6B Where firms assess that there are residual risks and apply either the Risk Weight Substitution Method or the Parameter Substitution Method, ~~a full substitution is not prudent,~~ the PRA expects such firms to consider whether a Pillar 2A add-on is appropriate.

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8e Please see paragraphs 2.13L to 2.13M of Statement of Policy, 'The PRA's methodologies for setting Pillar 2 capital', for details on how the PRA considers alternative methodologies used by firms for assessing idiosyncratic risk.

Market risk

2.13 Firms should provide in their ICAAP document sufficient supplementary evidence~~, to an auditable standard,~~ which shows how the firm's capital add-on for market risk is calculated. Specifically, firms need to provide evidence of sound approaches for assigning liquidity horizons in stressed market conditions~~situations~~, and demonstrate a prudent~~conservative~~ translation of liquidity horizons into appropriately severe stress scenarios.

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2.15 To this end, the PRA expects firms to:

- identify illiquid, one-way and/or concentrated positions;
- stress these positions (or risk factors) over an appropriate holding period (ie greater than ten days) and confidence level;
- identify any relevant capital mitigants already in place that directly relate to the illiquid, one-way or concentrated positions (eg capital for Risks not in Models ~~VaR~~ (RNIM~~V~~s), capital for the Default ~~Incremental~~ Risk Charge (~~I~~DRC) and reserves (such as bid/ask and prudential valuation reserves)); and
- suggest a Pillar 2A capital amount based on the stressed losses and capital mitigants or reserves.

2.15A The PRA also expects firms to assess any underwriting risks they are exposed to, particularly relating to any syndicated leveraged loan 'pipelines' (ie committed deals in the process of being syndicated, including signed but not countersigned positions). The PRA expects positions for which firms have signed the loan documentation to be included in their assessment, even where these have not yet been countersigned by the client. Further, to the extent that a firm considers itself 'on-risk' at an earlier stage in the process, such positions should also be included. The commitment pipeline is typically very 'lumpy' with significant single-name concentration, and can show large variation over time driven by deal flow. The PRA expects firms to take account of such variation in their assessments.

2.15B The PRA also expects firms to consider other market risks which may not be sufficiently captured through Pillar 1. Examples of such risks may include, but are not limited to, gap risk, intraday risks, non-interest rate market risks on fair-valued positions in available-for-sale books, and more generally, risks that may not be well captured under Pillar 1 risk measures (including any material risks not adequately captured under standardised approaches).

Counterparty Credit Risk and CVA risk

2.15C Firms should provide in their ICAAP document sufficient supplementary evidence which shows how their capital add-ons for counterparty credit risk (CCR) and credit valuation adjustment (CVA) volatility risk are calculated.

2.15D Settlement risk arising from a non-PvP (payment versus payment) settlement protocol may not be adequately capitalised under Pillar 1, and the PRA expects firms to measure their exposure to such risks. As exposure to settlement risk may be 'lumpy' with variation over time, firms' assessments of settlement risk should also recognise that their exposure to settlement risk varies through time.

2.15E In their assessment of counterparty credit risk, the PRA expects firms to consider residual risks from credit risk mitigation, wrong-way risk, settlement risk as well as any other material risks that may be inadequately captured in Pillar 1.

2.15F The PRA considers that Pillar 1 capital models can underestimate risk for certain portfolios. This may include strongly over-collateralised portfolios where Pillar 1 capital requirements may be inadequate, trades where collateral received is concentrated in a single security issuer, and large individual trades where the recognition of credit risk mitigation leads to comparatively low Pillar 1 requirements. The PRA expects firms to identify specific trades and portfolios where residual risks may be material and conduct their own assessment of the residual risks associated with those positions.

2.15G Other than for legally-connected specific wrong-way risk, the CCR capital framework assumes a generic and relatively low level of dependence between the creditworthiness of a firm's counterparty and the level of exposure to that counterparty. Wrong-way risk, where there is an adverse relationship between the exposure to the counterparty and the creditworthiness of that counterparty, arises in circumstances in which this assumption does not hold. The PRA expects firms to identify, monitor, manage, mitigate and capitalise their wrong-way risk appropriately. Misidentification of wrong-way risk leads to underestimation of risks and undercapitalisation. Concentrated wrong-way exposures (eg to 1 or more counterparties in a particular country with similar risk profiles) are of particular interest.

2.15H For their assessment of CVA volatility risk, the PRA expects firms to undertake an assessment demonstrating that Pillar 1 capital requirements do not underestimate the risk from CVA volatility (eg due to differences in scope between firms' accounting CVA and Pillar 1, or due to any material risks not adequately captured under the Pillar 1 approaches used by the firm).

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Operational risk

2.17 [Deleted] ~~In meeting the general standard referred to in Internal Capital Adequacy Assessment 10.1, a firm that undertakes market-related activities should be able to demonstrate to the PRA:~~

- ~~in the case of a firm calculating its capital requirements for operational risk using the Basic Indicator Approach or Standardised Approach, that it has considered; or~~

- ~~in the case of a firm with an Advanced Measurement Approach (AMA) permission, that it has complied with, the Committee of European Banking Supervisor's Guidelines on the management of operational risk in market-related activities published in October 2010.~~[25]

2.18 [Deleted] ~~In meeting the general standard referred to in Internal Capital Adequacy Assessment 10.1, a firm with an AMA approval should be able to demonstrate to the appropriate regulator that it has considered and complies with Section III of the EBA's Guidelines on the AMA — Extensions and Changes, published in January 2012.~~[26]

Expectations on firms' operational risk Pillar 2A assessment

2.18A As set out in Internal Capital Adequacy Assessment 10.1 in the PRA rulebook, firms must implement policies and processes to evaluate and manage their exposure to operational risk. This includes model risk and risks resulting from outsourcing, as well as low-frequency high severity events.

2.18B As part of meeting this requirement, the PRA expects firms to use scenario analysis, which should be part of the firm's operational risk management framework and inform the firm's risk mitigations and tail risk management. The PRA expects all firms to have a robust approach, proportionate to the nature, size and complexity of their business, to capture potentially severe operational risk exposures, achieving a soundness standard comparable to a 99.9% confidence interval over a one year. The approach should be well defined and documented.

25 ~~https://www.eba.europa.eu/regulation-and-policy/operational-risk/guidelines-on-the-management-of-operational-risk-in-market-related-activities.~~
26 ~~https://www.eba.europa.eu/-/guidelines-on-ama-extensions-and-chang-1.~~

2.18C The PRA expects a firm to use the scenario analysis to evaluate high severity events to inform their capital assessment. The PRA expects a firm to tailor its analysis, to ensure this is aligned to the risks to which it is most exposed. The PRA applies a proportionate approach when reviewing a firm's operational risk assessment and expects the scenario analysis should:

(i) be informed by the firm's risk register and represent key risks;

(ii) be informed by a combination of a top-down approach, to identify the key risks to the firm, and a bottom-up approach, to gather detailed information to provide a more granular view of the issues, to ensure a holistic view of operational risks;

(iii) where relevant, cover at least all the Basel event types, as set out in Annex 2 of the Operational Risk Part of the PRA Rulebook, which include internal fraud, external fraud, employment practices and workplace safety, clients, products and business practices, damage to physical assets, business disruption and system failures;

(iv) evaluate the potential impact of failures in risk mitigations[26a] and controls in selecting scenarios - for each scenario, estimate at least one operational loss associated assuming potential failures in risk mitigations and control;

(v) assess potential or probable operational risk events that have not yet materialised;

(vi) consider relevant changes in the business model and external environments that could affect the firm's operational risk exposure to high severity event; and

(vii) include a clear explanation of the approach to the operational risk assessment and justify the scenario analysis used.

2.18D The PRA expects firms to provide the following information in the ICAAP document as a minimum:

(i) brief information on their management of operational risk;

(ii) information on the operational risk scenarios they have considered in their ICAAP, covering a description of such scenarios and an assessment of their impact and likelihood; and

(iii) available data on historical loss events, expected losses and/or forecast losses.

Good practices in maintaining a robust operational risk measurement framework for significant firms

2.18E Where a significant firm's[26b] operational risk measurement framework aligns with the good practices set out in this section, the PRA will place greater emphasis on the firm's ICAAP when determining Pillar 2A capital for operational risk. Otherwise, the PRA will rely more on its methodology (as set out in Chapter 4 of the 'The PRA's methodologies for setting Pillar 2 capital')[26c] to inform the setting of a firm's Pillar 2A capital requirement.

2.18F The firm's calculation of its overall exposures to operational risk comprises both expected loss and unexpected loss, unless expected loss is adequately measured and accounted for.

26a Operational risk insurance is not recognised as a capital mitigant.
26b 'Significant firm' means a deposit-taker or PRA-designated investment firm whose size, interconnectedness, complexity and business type give it the capacity to cause significant disruption to the UK financial system (and through that to economic activity more widely) by failing or carrying on its business in an unsafe manner.
26c https://www.bankofengland.co.uk/prudential-regulation/publication/2015/the-pras-methodologies-for-setting-pillar-2-capital.

2.18G The firm's scenario analysis contains the following elements, in addition to the expectations set out in the previous section (2.18A to 2.18D):

(i) The scenario analysis is repeatable and designed to reduce subjectivity and biases as much as possible.

(ii) The responsibilities related to the governance of ICAAP and capital decision are clearly articulated and allocated – for example, consistency in the process is provided by qualified facilitators; all relevant business, subject matter experts and operational risk management functions are involved; and all scenario participants are appropriately trained.

(iii) The operational risk management function (second line of defence) oversees and challenges the scenario process independently, to ensure the completeness and appropriateness of scenario selection, the reliability and robustness of scenario quantification, the relevance of management actions.

(iv) The scenario analysis is based, to the extent possible, on the relevant internal and external loss data, relevant information on the internal and external environment, and the internal controls. This data should be subject to an objective and unbiased selection process. Relevant information is provided to all scenario participants in a structured and well-documented way.

(v) The scenario quantification produces credible and reliable estimates of the operational risk loss of high-severity events, which include a clear identification and linkage to risk drivers, exposures to risk and loss estimates. The calculation used to derive the estimated amount of the operational risk loss, and the associated assumptions, are clearly justified and documented. Over time, firms should validate and reassess scenario quantification through comparison to actual loss experience to ensure their reasonableness.

(vi) The scenario analysis is fully integrated into a firm's operational risk management framework and measurement systems. The firm uses all the elements of the firm's operational risk management framework to inform the scenario analysis; reflects the scenario analysis in its operational risk capital assessment; and uses scenario analysis as an effective tool to assess, manage and mitigate operational risk.

(vii) The scenario outcomes, including scenario selection, are presented and approved by relevant governance committees.

2.18H Where relevant, the firm uses internal[26d] and external loss data, as well as any information related to the business environment and control factors, to inform the assessment of operational risk exposure. This is particularly relevant for exposure to high-impact events.

2.18I In cases where the firm uses relevant external data in assessing low-frequency high severity losses, the firm:

(i) has a systematic process for determining the situations for which external data shall be used and the methodologies used to incorporate the data in its measurement system; and

(ii) regularly reviews the conditions and practices for external data, documents them and subjects them to periodic independent review.

2.18J When evaluating the potential impact of failures in the risk mitigants and internal controls in the scenario analysis, the firm captures potential changes that could affect the firm's operational risk profile.

[26d] In accordance with Chapter 7 (Identification, collection and treatment of loss data) of the Operational Risk Part of the PRA Rulebook.

These changes could include increased operational risk exposure due to greater complexity, increased activities or business volume, and/or the external environment.

2.18K A firm may recognise diversification across operational risk sub-categories only where its systems for measuring dependencies are sound and implemented with integrity. When doing so, the firm considers the uncertainty surrounding such estimates, particularly in periods of stress. In addition, the firm validates its dependencies and assumptions using appropriate quantitative and qualitative techniques.

2.18L To ensure the requirement that its internal measurement system for operational risk is closely integrated into its day-to-day risk management processes (as set out in Rule 6.2(2) of the Operational Risk Part of the PRA rulebook) is fulfilled, the firm:

(i) uses all the elements of its operational risk management framework to inform the assessment of the operational risk exposure;

(ii) uses the output of the measurement systems as an integral part of the process of monitoring and controlling the firm's operational risk profile; and

(iii) provides adequate reporting on the operational risk exposure to relevant functions within the firm.

2.18M When applicable, the firm complies with the Model Risk Management principles for banks set out in the SS1/23 – Model risk management principles for banks.

2.18N The firm's ICAAP contains the following elements, in addition to the expectations set out in the previous section (2.18A to 2.18D):

(i) overview of the operational risk management and measurement framework;

(ii) key outputs of the operational risk management framework components (eg top risks, breaches of risk appetite, aggregate results of the risk and control self-assessment, audit issues);

(iii) trend and material historical losses and scenario analysis;

(iv) details of the operational risk capital requirement, including a breakdown across Basel event types; and

(v) where relevant and subject to 2.18L, comparison of operational risk capital pre and post diversification.

Guidance on business continuity plan

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2.20 [Deleted] ~~In addition, the PRA does not expect that smaller firms will complete the operational risk data items but expects such firms to provide in their ICAAP document at least the following information (historical losses at an aggregate level are regularly available to the PRA via COREP 17):~~

~~(i) forecast operational risk losses, broken down between conduct and non-conduct losses and by future year; and~~

~~(ii) information on the operational risk scenarios they have considered in their ICAAP, covering a description of such scenarios and an assessment of their impact and likelihood.~~

Pension obligation risk

2.21 [Deleted] ~~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.~~

2.22 [Deleted] ~~The firm's own assessment and the stress tests on the accounting basis can be reduced by:~~

- ~~offsets and management actions; and~~
- ~~any pension scheme deficit deducted from Common Equity Tier 1 (CET1).~~

2.23 The PRA expects firms to carry out their own assessment of the appropriate level of Pillar 2A pension obligation risk capital in their ICAAP. Firms should use methodologies and assumptions that are consistent with their approach to risk management and are therefore not restricted to using their relevant accounting basis (IAS 19 or similar) ~~basis~~ in carrying out this assessment.

2.23A The assessment should be proportionate to the nature, scale and complexity of the firm's activities, considering factors such as the size of the scheme, the scheme's funding level, investment strategy and the presence of secured benefits.

2.24 In carrying out their assessment, firms should consider risks to the financial position of their pension schemes consistent with a stress event that has no more than a 1 in 200 probability of occurring over~~in~~ a one-year period.

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2.25A Following a buy-in, as part of the firm's ICAAP assessment, the PRA would expect consideration to be made for the residual risks remaining, such as counterparty risk to the insurer. The ICAAP should document the firm's assessment of these risks.

2.25B The firm's own assessment can be reduced by:

- offsets and management actions; and
- any pension scheme deficit deducted from Common Equity Tier 1 (CET1).

2.26 [Deleted] ~~As part of their ICAAP submission, firms are required to calculate and (if they have a defined benefit pension scheme) report the stressed accounting value of their pension scheme's assets and liabilities using stress scenarios specified by the PRA in accordance with PRA Statement of Policy, 'The PRA's methodologies for setting Pillar 2 capital' and Reporting Pillar 2, 2.6 as set out in the PRA Rulebook. This requirement is in addition to the firm's own assessment referred to above, unless the data required in that data item have already been reported to the PRA by other means. In doing so firms are expected to:~~

- ~~calculate the stressed value of assets and liabilities assuming all the elements of the stress apply instantaneously and simultaneously;~~
- ~~decompose the IAS 19 discount rate into a risk-free element and a credit spread element. Firms should make use of their own methodology to do so but should provide a description of the approach taken in their ICAAP. The long-term interest rate stress should be applied to the risk-free element and the credit stress to the credit spread element in order to derive the stressed discount rate; and~~
- ~~use their own methodology to decompose the yield on bonds into a risk-free element and a credit spread element and describe the approach taken in their ICAAP.~~

2.27 [Deleted] ~~The PRA expects the valuation measure of liabilities to be the same as that used for International Financial Reporting Standards (IFRS) reporting. The PRA expects firms' approaches to setting the valuation assumptions to be stable over time and any changes to the approach should be justified in the ICAAP document.~~

2.28 [Deleted] ~~More information on the scenarios is available in PRA Statement of Policy, 'The PRA's methodologies for setting Pillar 2 capital'. The PRA scenarios are highly simplified by design and firms should decide which stresses to apply to individual asset and liability classes. The broadest possible interpretation should be used (eg a single stress is specified for equity prices); and this should be applied to all categories of investments that exhibit properties similar to listed equities, such as UK equities, overseas equities, unlisted equities, private equity and limited partnerships.~~

2.29 [Deleted] ~~Where firms believe that the scenarios produce inappropriate levels of capital for their pension schemes, they should provide evidence of this together with a detailed explanation in their ICAAP document.~~

2.30 The PRA expects firms to explain any offsets or management actions they propose. When considering management actions and offsets, firms must clearly demonstrate that offsets are valid and that management actions are realistic. They must also demonstrate that both offsets and management actions do not result in double counting and would be effective under stressed conditions. Where practical, management actions will be formulated after discussion with pension scheme trustees.

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Foreign currency lending to unhedged retail and SME borrowers

2.37 Foreign currency lending is defined in the EBA Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP).[28]

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3 Stress testing, scenario analysis and capital planning

…

Common stress scenarios

3.16 As part of its ~~Annual S~~stress ~~T~~testing ~~framework~~approach, the Bank of England regularly publishes a common stress scenario aimed at assessing the UK banking system's capital adequacy. This scenario is run concurrently across a number of participating firms~~, on an annual basis~~.[33a]

…

3.19 More generally, all firms should continue to develop their own scenarios and ensure that these are as severe in relation to their business model as the Bank Capital Stress Test~~concurrent stress testing~~ scenario or equivalent benchmark ~~(for firms participating in concurrent stress testing) or the~~ scenario published by the PRA ~~(for all other firms)~~.

3.20 The PRA may ask some firms to run the Bank Capital Stress Test~~concurrent stress test~~ scenario~~s~~ or equivalent benchmark~~the PRA~~ scenario as part of their range of stress scenarios for Pillar 2 capital planning.

28 ~~https://www.eba.europa.eu/documents/10180/935249/EBA-GL-2014-13+(Guidelines+on+SREP+methodologies+and+processes).pdf~~ https://www.bankofengland.co.uk/-/media/boe/files/paper/2020/december/guidelines-on-common-procedures-and-methodology-for-srep.pdf. Title 1 'Subject matter, definitions and level of application' of the EBA Guidelines, Section 2, pages 16 and 18, provide definitions of 'FX lending' and 'unhedged borrowers'.

33a The Bank of England's approach to stress testing the UK banking system: https://www.bankofengland.co.uk/stress-testing/2024/boes-approach-to-stress-testing-the-uk-banking-system.

Asking firms to run common scenarios, or scenarios that are broadly comparable in terms of severity (eg for firms with different business models) will allow supervisors to more easily compare and benchmark individual results and firms' approaches to stress testing.

...

4 Reverse stress testing

…

4.7 In carrying out its reverse stress testing, a firm could consider scenarios in which the failure of one or more of its major counterparties or a significant market disruption arising from the failure of a major market participant, whether or not combined, would cause the firm's business to fail. For an RFB, this supervisory statement should be read in conjunction with SS8/16.[41]~~.~~ SS8/16 sets out the PRA's expectation that an RFB sub-group should consider the failure of group entities that are not members of the RFB sub-group as part of reverse stress testing.

…

5 The SREP

…

5.5 The SREP will also consider:

…

- the exposure to and management of foreign currency lending risk to unhedged retail and SME borrowers by firms, in line with Title 6, section 2 paragraphs 158–59 of the EBA's Guidelines on common procedures and methodologies for the SREP;[42]

…

5.8A In applying the principle of proportionality to the SREP, the PRA ~~adheres to the approach in section 2.4 of the EBA Guidelines on common procedures and methodologies for the SREP which~~ relates the frequency and intensity of the SREP to firms' nature, scale and complexity. The PRA categorises firms according to their significance to the stability of the UK financial system, in accordance with the criteria set out in 'The PRA's approach to banking supervision'.[43] The PRA has additional criteria for applying the principle of proportionality to particular aspects of the SREP:

- Smaller firms have fewer reporting requirements under the Pillar 2 reporting part of the Rulebook;[44]
- A proportionate approach is applied to the operational risk Pillar 2A add-for non-Category 1 firms; and
- The PRA provides more proportionate scenarios for smaller firms' own stress testing. For example, the approach applied to the PRA buffer for new banks takes into account their recent entry to the market.[45]

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41 'Ring-fenced bodies', November 2017: https://www.bankofengland.co.uk/prudential-regulation/publication/2016/ring-fenced-bodies-ss.
42 See footnote (1) on page 14 of 'Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP)': https://www.bankofengland.co.uk/-/media/boe/files/paper/2020/december/guidelines-on-common-procedures-and-methodology-for-srep.pdf.
43 Paragraphs 34 and 35~~2~~ https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/approach/banking-approach-2023.pdf.
44 Rule 2.3 of the Pillar 2 Part of the PRA Rulebook.
45 Non-systemic UK banks: The Prudential Regulation Authority's approach to new and growing banks https://www.bankofengland.co.uk/prudential-regulation/publication/2020/new-and-growing-banks.

…

The setting of Pillar 2A capital requirements and the PRA buffer

Pillar 2A Capital Requirements

…

5.16 Where the PRA sets a firm-specific Pillar 2A capital requirement it will generally specify an amount of capital (Pillar 2A) that the firm should hold at all times in addition to the capital it must hold to comply with the CRR (Pillar 1). It will usually do so by stating that the firm should hold capital of an amount equal to a specified percentage of the firm's Pillar 1 RWAs (the total risk exposure amount calculated in accordance with Article 92(3) of the CRR), plus one or more static add-on in relation to specific risks in accordance with the overall Pillar 2 rule in Internal Capital Adequacy Assessment 3.1. The PRA requires firms to meet Pillar 2A with at least 56.25% CET1 capital, no more than 43.75% additional Tier 1 (AT1) capital and no more than 25% Tier 2. For these purposes, firms should follow the provisions on the definition of capital set out in the Definition of Capital Part of the PRA Rulebook and Supervisory Statement 7/13.[47]

…

Failure to meet TCR and use of the PRA buffer

…

5.33 Use of the PRA buffer is not itself a breach of capital requirements or TCs. The PRA expects firms to use their PRA buffer (and indeed other capital buffers)[51]~~)~~ in times of stress. Use of buffers (including both the combined buffer and PRA buffer) are what firms and the PRA model as part of their stress tests. The PRA does not expect or require firms to finance themselves with more capital than the total of their regulatory requirements and buffers. However, where a firm has a PRA buffer in place, it should not use that buffer in the normal course of business or enter into it as part of its base business plan.

…

47 PRA Supervisory Statement 7/13, 'Definition of capital (CRR firms)~~CRD IV and capital~~'~~, December 2013~~: https://www.bankofengland.co.uk/prudential-regulation/publication/2013/crdiv-and-capital-ss.

51 Refer to SS6/14 'Implementing ~~CRD IV: C~~capital buffers' for details on the use of the capital buffers: https://www.bankofengland.co.uk/prudential-regulation/publication/2014/implementing-crdiv-capital-buffers-ss