BANK OF ENGLAND
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The Pillar 2 framework – background

Regulatory context

1. The changes to the Pillar 2 policy framework implement Section III of the Capital Requirements Directive (2013/36/EU) and are in line with the European Banking Authority's Supervisory Review and Evaluation Process (EBA SREP) Guidelines[1].

2. Changes are also required to the capital planning buffer (CPB) regime following the introduction of the CRD IV buffers. The statement of policy and the policy statement discuss the factors that will inform the setting of the new PRA buffer and how the PRA intends to phase it in.

3. The purpose of Pillar 2 capital is to:

   - ensure firms have adequate capital to support the relevant risks in their business;
   - ensure firms have appropriate processes to comply with CRD IV[2];
   - encourage firms to develop and use better risk management techniques in monitoring and managing their risk;
   - enable firms to continue to meet their capital requirements during periods of stress; and
   - ensure systemically important firms are held to higher standards.

4. Pillar 2 capital therefore acts to further the safety and soundness of firms, in line with the PRA's general objective.

5. The Supervisory Review and Evaluation Process (SREP) is the PRA's review and evaluation of:

   - the arrangements, strategies, processes and mechanisms implemented by a firm to comply with regulatory requirements laid down in PRA rules and the Capital Requirements Regulation;
   - the risks to which a firm is or might be exposed; and
   - further risks revealed by stress testing.

6. There are two mains areas that the PRA considers when conducting a SREP:

   (i) risks to the firm that are either not captured, or not fully captured, under the Pillar 1 requirements of Capital Requirements Regulation (CRR); and

   (ii) risks to which the firm may become exposed over a forward-looking planning horizon (eg due to changes to the economic environment).

   The PRA refers to the first area as Pillar 2A and to the second as Pillar 2B. In addition to the Pillar 1 requirements of the CRR, the PRA regards capital held under Pillar 2A as the minimum level of regulatory capital a firm should maintain at all times in order to cover adequately the risks to which it is or might be exposed, and to comply with the overall financial adequacy rule. Pillar 2B is a capital buffer which helps to ensure that firms can continue to meet minimum requirements (Pillar 1 and Pillar 2A) during a stressed period.

7. Under Pillar 1, firms are required to calculate their capital requirements in accordance with the methodologies agreed in the CRR. Under Pillar 2, firms are required to undertake a regular assessment of the amounts, types and distribution of capital that they consider adequate to cover the level and nature of risks to which they are, or might be exposed. This assessment may lead to firms identifying risks that are inadequately covered under Pillar 1 or not covered at all.

8. As part of the PRA's supervision of firms, the PRA has developed its own methodologies for assessing whether the amount and quality of capital held by a firm is sufficient to cover the

[1] Available at www.eba.europa.eu/documents/10180/935249/EBA-GL-2014-13+(Guidelines+on+SREP+methodologies+and+processes).pdf.
[2] The Capital Requirements Regulation (575/2013) (CRR) and Capital Requirements Directive (2013/36/EU) (CRD), jointly 'CRD IV.

nature and level of the risks to which a firm is, or might be exposed. The output of these methodologies, supervisory judgement and a firm's own assessment, collectively inform the PRA's setting of individual capital guidance (ICG) and, if needed, the PRA buffer.

9. The PRA continues to expect firms to carry out their own assessment of the appropriate level of Pillar 2 capital and to communicate it clearly in the Internal Capital Adequacy Assessment Process (ICAAP) document.

The PRA's approach to banking supervision

10. The PRA first published its approach document in October 2012.[3] This explained that the SREP, including guidance about the adequacy of a firm's capital, is part of a continuous assessment and is carried out with differing frequencies given the nature, scale and complexity of a firm.

11. The reformed Pillar 2 framework emphasises the key features of the PRA supervisory approach:
    - the SREP will focus on the material risks to which a firm is exposed;
    - supervisory judgment will be a key input to the PRA's decision on the setting of ICG and the PRA buffer; and
    - the PRA will continue to be proportionate in its approach to assessing capital, especially when considering firms with the lowest potential impact on the stability of the financial system.

12. The reform of the Pillar 2 framework aims to:
    - streamline the SREP by clarifying the inputs to be used by supervisors to inform the setting of additional capital;
    - strike the right balance between supervisory judgement on the one hand and constraints imposed to ensure consistent outcomes on the other; and
    - publish methodologies and more generally allow for greater transparency, which in turn promotes PRA accountability and capital predictability.

Disclosure

13. The PRA wrote to firms in 2014 clarifying its approach to firms publicly disclosing information relating to ICG. The PRA reminded firms that ICG letters are prepared for regulatory purposes only, and that their contents could be misunderstood or misinterpreted if disclosed out of context. The letter also recognised increasing pressure on firms to provide greater transparency to investors, which the PRA accepted is partly driven by regulatory reforms.

14. The letter stated the PRA's general position that firms should treat their ICG as confidential, unless they are required to disclose it by law. But the letter also said that the PRA would consider firms disclosing information relating to ICG on a case-by-case basis. Since then, a number of firms have voluntarily disclosed their total ICG, notifying the PRA in advance.

15. Taking into account the market impact of Pillar 2 disclosures and the proposed enhancements to Pillar 2 methodologies and transparency of the Pillar 2 framework, the PRA is changing its approach to Pillar 2 disclosure.

PS7/13 policy changes

16. In December 2013, the PRA made changes to the Pillar 2 framework as set out in PS7/13[4], whereby:
    - the PRA increased the quality of Pillar 2A capital to reflect the composition of Pillar 1 capital. As of January 2015, all firms are expected to hold at least 56% of Pillar 2A in Common Equity Tier 1 capital (CET1), and no more than 25% in Tier 2 capital;

[3] The PRA's approach to banking supervision is evolving and the approach document is, likewise, updated at appropriate times. Since October 2012, the approach document has been updated in April 2013 and June 2014. All versions are available at http://www.bankofengland.co.uk/publications/Pages/other/pra/supervisoryapproach.aspx.

[4] Policy Statement 7/13 'Strengthening capital standards: implementing CRD IV, feedback and final rules'; http://www.bankofengland.co.uk/pra/Pages/publications/implemcrdiv.aspx.

- pension obligation risk should be treated like other Pillar 2A risks in terms of the quality of capital held against it, given that pension obligation risk can crystallise while a firm is a going concern and given the materiality and volatility of accounting measures of pension deficits;
- the purpose of the PRA buffer is to enable a firm to meet its minimum capital requirements under stress, in line with the PRA's risk appetite;
- buffers determined by the Financial Policy Committee (FPC) in deploying its macroprudential instruments should be additional to any PRA buffer assessment, in order to ensure the effective transmission of the FPC decisions;
- capital used to meet a firm's CRD buffers may not be used to meet its PRA buffer;
- capital that firms use to meet their minimum requirements (Pillar 1 and Pillar 2A) cannot be counted towards meeting their buffers; and
- the PRA buffer should be held in CET1, consistently with the CRD IV buffers.

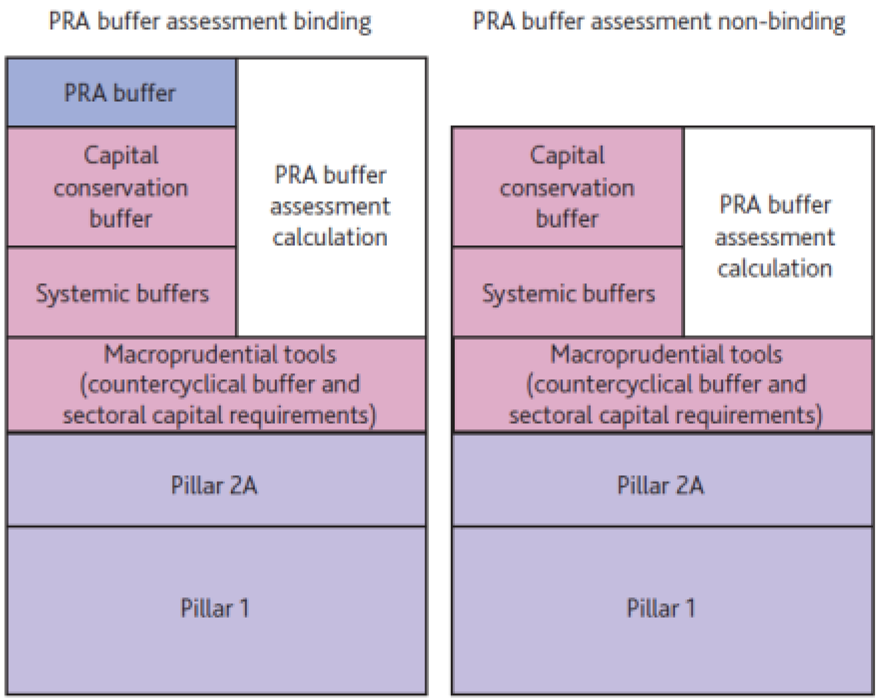
July 2015 - PRA publications on the Pillar 2 framework

On 29 July 2015, the PRA published:

- Policy Statement 17/15 *'Assessing capital adequacy under Pillar 2'*;
- Statement of Policy *'The PRA's methodologies for setting Pillar 2 capital'*;
- Supervisory Statement 31/15 *'The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)'.* This replaces SS5/13 and SS6/13; and
- Supervisory Statement 32/15 *'Pillar 2 reporting, including instructions to complete data items FSA071 to FSA082'*.

All policy publications are available via the Policy Statement 17/15 landing page[5], materials and information set out in SS32/15 on data items FSA071 to FSA082 are available in the Regulatory Data section of the Bank's website[6].

The Statement of Policy contains the following diagram of the Pillar 2 framework.



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[5] http://www.bankofengland.co.uk/pra/Pages/publications/ps/2015/ps1715.aspx
[6] See http://www.bankofengland.co.uk/pra/Pages/regulatorydata/formscrdfirms.aspx