Policy Statement | PS17/15

Assessing capital adequacy under Pillar 2

July 2015

BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

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PRUDENTIAL REGULATION
AUTHORITY

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This policy statement contains the final rules, statement of policy and supervisory statements for Pillar 2 capital policy.

1 Introduction

1.1 This policy statement (PS) sets out the Prudential Regulation Authority's (PRA) responses to the feedback on *PRA Consultation Paper 1/15* ('the CP'): 'Assessing capital adequacy under Pillar 2'. It sets out changes to rules and supervisory statements[1][2] and finalises a statement of policy: 'The PRA's methodologies for setting Pillar 2 capital'.[3] The PS is relevant to banks, building societies and PRA-designated investment firms.

1.2 The Pillar 2 capital framework for the banking sector is intended to ensure that firms have adequate capital to support the relevant risks in their business, and that they have appropriate processes to ensure compliance with CRD IV.[4] It is also intended to encourage firms to develop and use better risk management techniques in monitoring and managing their risks. Pillar 2 therefore acts to further the safety and soundness of firms, in line with the PRA's objectives.

1.3 The PRA is required by the Financial Services and Markets Act 2000 to have regard to any representations made to the proposals in its consultations, and to publish an account, in general terms, of those representations and its response to them. The PRA received 18 responses to the CP.

1.4 This PS follows the same chapter structure as CP1/15. Where relevant, each section includes:

- the approach taken on the most significant issues raised by respondents, in particular noting those areas where the PRA is making a substantive change to the proposals contained in the CP. Where an issue is not addressed, the PRA is maintaining the policy approach set out in the CP; and

- clarifications, where the PRA considers it appropriate to use this PS to clarify issues of uncertainty raised in responses to the CP.

2 Pillar 2A methodologies

Role of the Internal Capital Adequacy Assessment Process

2.1 Some respondents asked whether firms should continue to develop and use their own methodologies for the assessment of risks where those methodologies differ from the PRA's. There was some concern that the approaches consulted on in the CP lowered incentives for firms to develop adequate risk management.

2.2 A firm must carry out an Internal Capital Adequacy Assessment Process (ICAAP) in accordance with the PRA's Internal Capital Adequacy Assessment (ICAA) rules. These require firms to have in place sound, effective and comprehensive strategies and processes to assess and maintain, on an ongoing basis, the amounts, types and distribution of financial resources they consider adequate to cover the nature and level of the risks to which they are or might be exposed. The existence of the PRA's own methodologies does not remove this obligation. The PRA expects a firm's ICAAP to be the responsibility of a firm's management body and to be an integral part of the firm's management process and decision making. The PRA's methodologies inform the PRA's setting of Individual Capital Guidance (ICG) alongside supervisory judgement and a firm's own assessment. 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.

Transparency

2.3 Respondents welcomed the transparency of the PRA's approach to Pillar 2, and some requested further detail on the PRA's methodologies for credit concentration, operational and pension risk, and the determination of the PRA buffer, including the risk management and governance (RM&G) scalar.

2.4 By setting out its methodologies in a statement of policy, the PRA has significantly increased the transparency of its supervisory approach. The PRA is reluctant to increase transparency further still (for instance, by publishing parameters underlying some of the methodologies) as that could undermine supervisory judgement and increase the risk of arbitrage. Transparency around the RM&G scalar is constrained as the risk element scores of the PRA's risk model to which the scalar is linked cannot be disclosed to any firms. The PRA has set out the risks that the PRA buffer is intended to capture but, as the determination of the buffer takes into account several factors (including stress testing results), there are limitations in the transparency of the PRA's methodology for setting the PRA buffer. We expect that for most firms, most of the time, the CRD IV buffers are likely to be sufficient, once fully phased in; and the RM&G scalar is intended to address significant weaknesses only.

Credit risk

2.5 Under the new methodology, where the PRA believes firms' credit risk to be undercapitalised by the standardised approach (SA), for each key portfolio it will examine the firm's SA average risk weight compared to the average of internal ratings-based (IRB) firms' risk weights (in the form of a

(1) *PRA Supervisory Statement SS31/15*, 'The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)', July 2015; www.bankofengland.co.uk/pra/Pages/publications/ss/2015/ss3115.aspx.
(2) *PRA Supervisory Statement SS32/15*, 'Pillar 2 reporting, including instructions for completing data items FSA071 to FSA082', July 2015; www.bankofengland.co.uk/pra/Pages/publications/ss/2015/ss3215.aspx.
(3) *PRA Statement of Policy*, 'The PRA's methodologies for setting Pillar 2 capital', July 2015; www.bankofengland.co.uk/pra/Pages/publications/sop/2015/p2methodologies.aspx.
(4) The Capital Requirements Regulation (575/2013) (CRR) and Capital Requirements Directive (2013/36/EU) (CRD), jointly 'CRD IV'.

benchmark). It will also consider a range around the average to support supervisory judgement.

2.6 An 'unders-and-overs' approach has been adopted to determine whether a Pillar 2A capital add-on for credit risk is required. In practice, this means that where the PRA assesses that the SA Pillar 1 capital charge overestimates the level of capital required when compared to the capital requirement for an average IRB firm, the excess can be used against capital shortfalls arising from other portfolios where credit risk is underestimated under the SA, again relative to the benchmark of the capital required for an average IRB firm. This means that some portfolios or loan types may be capitalised at lower levels than the benchmarks, provided that at an aggregate level the SA firm is adequately capitalised against its total credit risk. The methodology also applies to IRB firms' exposures which are capitalised under the SA approach.

2.7 Some respondents were concerned that the proposed methodology would override Pillar 1 risk weights and suggested that perceived shortcomings should be addressed in the Pillar 1 framework rather than under Pillar 2. Respondents also asked for clarification on the scope of application of the methodology, the use of supervisory judgement and the approach for assessing products without IRB benchmarks.

2.8 Perceived shortcomings in Pillar 1 risk weights for IRB firms are addressed through Pillar 1 model adjustments only. Such adjustments are not possible for SA portfolios so, where the PRA perceives under-capitalisation, it believes it is necessary to use Pillar 2 to ensure a firm's safety and soundness. The Pillar 2A methodology therefore only applies to IRB firms' exposures capitalised under the SA: it does not apply to exposures capitalised under the IRB approach.

2.9 The PRA's methodology suggested that credit risk within SA portfolios is unlikely to be undercapitalised on an aggregate basis, so the PRA does not expect the methodology to be routinely applied. Firms will only be asked to submit data to apply the methodology where supervisors have reason to believe there is likely to be an aggregate undercapitalisation of SA portfolios. High loan to value (LTV) lending is one factor that could prompt that decision, but as **Table A** of the statement of policy on Pillar 2 implies, high LTV lending on its own is unlikely to lead to a credit risk add-on. The size of add-ons will be a matter of supervisory judgement, informed by the extent to which the PRA believes that a firm's Pillar 1 credit risk capital falls short of the IRB benchmark.

2.10 Credit risk mitigation — such as mortgage indemnity insurance — may be taken into account by supervisors.

Operational risk

2.11 The PRA proposed applying a methodology aimed at ensuring a fair and consistent treatment of Category 1 firms. A capital range tool has been developed to support supervisory judgement in determining Pillar 2A capital requirements for non-conduct related operational risk. The PRA has also proposed a consistent treatment of conduct-related operational risk losses, based on supervisory judgement and other information.

Scope of application

2.12 Respondents asked for clarification on the scope of application of the new methodology, in particular the circumstances in which the PRA would apply the new methodology to non-Category 1 firms, and the timetable for transition if a supervisor determines that the approach should be applied.

2.13 The methodology will be applied to all Category 1 firms that are using the Basic Indicators Approach, the Standardised Approach or the Alternative Standardised Approach to calculate Pillar 1 operational risk capital requirements. It may also be applied to firms that are assessed to be lower potential impact firms, depending on the size and complexity of a firm, as well as the sophistication of its operational risk management.

2.14 Where a supervisor determines a non-Category 1 firm will be brought into scope, or where a firm's potential impact is reassigned as Category 1, supervisors will agree a fair and reasonable timetable for assessment under the new methodology.

2.15 The methodology will not be applied to firms using the Advanced Measurement Approach (AMA) unless supervisors have identified outstanding remedial actions associated with their AMA approval. In such cases, supervisors will notify affected firms and, where the methodology is applied, additional Pillar 2A capital may be required.

Conduct risk

2.16 Respondents suggested that the proposed methodology does not give credit to firms that have learned from past misconduct and also that capital is not the best mitigant for conduct risks. Some respondents were also concerned about using Clients Products and Business Practices (CPBP) as a proxy for conduct losses.

2.17 While a firm might have learned from previous conduct issues, which could reduce the prospect of future misconduct, conduct losses from products already sold remain a risk. The PRA believes that this risk should be capitalised. Where firms' behaviour has improved and conduct losses have decreased, this will feed into the PRA's assessment of conduct-related operational risk over time.

2.18 CPBP losses have been chosen as a proxy to encourage consistency of treatment of conduct risk losses across firms. The PRA is aware that the CPBP category can also capture non-conduct losses but that is just one element feeding into the overall assessment of conduct risk.

Credit concentration risk

2.19 The Pillar 1 approach for credit risk is calibrated on the assumption that firms' assets portfolios are perfectly diversified: this is not the case. The PRA proposed that firms be required to calculate a credit concentration risk measure, the Herfindahl-Hirschman Index (HHI) for single name, sectoral and geographical credit concentration risk, based on risk-weighted assets (RWAs) to reflect a degree of risk sensitivity. The PRA proposed an approach to map a firm's HHI into capital range add-ons. This was calibrated using multi-factor capital models which take into account default rate volatilities, and also correlations within regions and sectors.

Risk sensitivity versus standardisation of the methodology

2.20 Respondents noted that adopting a standardised methodology is inflexible and may not adequately capture different sources of credit concentration, and suggested instead relying on firms' economic capital models, and only using the methodology as a benchmarking tool. They also noted that the methodology failed to capture credit quality, credit distribution or recovery.

2.21 The PRA recognises that a degree of compromise between risk sensitivity and standardisation is required if the PRA is to achieve an appropriate level of consistency across firms. The PRA therefore has decided not to alter its approach. Credit quality, distribution and recovery are reflected in Pillar 1 RWAs which are used when calculating the HHI for each source of concentration. The PRA therefore believes the credit concentration risk methodology to some degree captures these attributes.

Use of risk-weighted assets

2.22 Respondents expressed other concerns about the use of RWAs. One respondent noted that while the HHI is a standard measure of concentration, RWAs do not reflect portfolio correlations which are a key driver of credit concentration risk. Another respondent was concerned that basing the assessment on RWAs instead of total exposures could lead to volatile concentration risk add-ons if there is a downgrade of a large counterparty.

2.23 While it is correct that Pillar 1 RWAs do not consider specific portfolio correlations, the capital ranges for each concentration risk bucket were calibrated using portfolio correlations in a multifactor model. To simplify the methodology, the PRA mapped the capital range add-ons produced by the multifactor model to HHI measures. The additional capital required for credit concentration risk is therefore determined indirectly by using portfolio correlations.

2.24 The PRA recognises that changes in RWAs between assessments may result in a firm being assigned to a different credit concentration risk bucket, but the ranges available within each risk bucket should enable supervisors to limit volatility.

Using the mid-point of the capital range within each risk bucket

2.25 To promote consistency of judgement, the PRA proposed that there will be a default presumption that, unless there are compelling reasons to deviate from it, the credit concentration risk add-on will fall to the mid-point of the capital range for each credit concentration risk bucket.

2.26 To increase fairness and flexibility, respondents asked if the PRA could use linear interpolation to determine the credit concentration risk add-on, rather than use the mid-point of the capital range as a default presumption.

2.27 The PRA does not believe that this would increase fairness or flexibility. The relationship between the capital add-ons and the HHI measures is not linear, which is why the methodology groups levels of concentration into risk buckets and provides a capital add-on range for each risk bucket.

2.28 The PRA believes that using the mid-point of each bucket as a starting point will achieve greater fairness and flexibility while promoting consistency of judgement. When deciding whether to deviate from the mid-point, supervisors may consider a range of factors, including: firms' own concentration risk assessments; firms' ability to manage concentration risk; the degree to which conservatism is reflected in a firm's Pillar 1 RWAs; instances where portfolio correlations are not adequately captured; any other factors not adequately captured under the quantitative assessment; and business models.

Treatment of liquid assets

2.29 Some respondents mentioned that smaller firms are likely to have high single-name concentration due to substantial credit balances with their principal clearing bank for liquidity purposes. They suggested that the PRA could develop a separate HHI scale with lower capital ranges for firms whose wholesale counterparties are exclusively financial institutions. Others were concerned that the exclusion of sovereigns as a sector may make a firm look more concentrated than otherwise.

2.30 The PRA recognises that some smaller institutions have short-term exposures to financial institutions for liquidity purposes and in practice might find it more difficult to diversify than larger firms. Supervisors may exercise judgement for smaller firms where they identify that the credit concentration risk methodology could overstate risks, or could incentivise risk-taking behaviour.

2.31 The exclusion of sovereign exposures as a sector should not result in a higher credit concentration risk add-on; these exposures are typically risk weighted at zero, so they would not increase total portfolio RWAs, or lower the HHI measure.

Definitions of sectors and regions

2.32 Respondents noted that the PRA had defined sectors quite broadly and, as a result, could miss some concentration risks but spuriously capture other non-existent concentration risks, in particular via the use of outdated standard industry classification (SIC) codes rather than NACE (Nomenclature of Economic Classification) codes. They also expressed concern about the exclusion of sovereigns as a sector. Other respondents suggested that pension funds should be separated from other financial institutions.

2.33 Broad sector categories were chosen for simplicity so that the credit concentration risk methodology can be applied to all firms. The PRA recognises that the broadness of the sectors means that some of the correlations are imperfect. This was taken into account when setting the model parameters. The sectors are broadly aligned to SIC and NACE codes.

2.34 The PRA has no evidence that sovereign defaults — as a group — are driven by a single economic factor, so will continue to exclude sovereigns from concentration metrics.

2.35 The PRA disagrees with the suggestion to separate pension funds from other financial institutions; in the PRA's view, zero or low defaults in the most recent crisis does not mean there is no potential for correlation. The PRA's analysis also shows that excluding pension funds would not have a material impact on a firm's sector concentration bucket.

Interest rate risk in the banking book

2.36 The PRA received feedback from respondents on interest rate risk in the banking book (IRRBB). This methodology is not being changed at this point but the responses will be taken into account when the PRA consults on the assessment of IRRBB under Pillar 2 following the conclusion of Basel work on IRRBB.

Pension obligation risk

2.37 The PRA proposed publishing two stress scenarios that firms will be expected to run as part of their ICAAP submission. This is in addition to the firm's own assessment of the appropriate level of Pillar 2A pension obligation risk capital. The higher of the two prescribed stress scenarios will form the starting point of the PRA assessment. Where the PRA considers that the risk profile of a firm's pension scheme deviates significantly from the assumptions underlying the published stress scenarios, it will use other models to compare against the firm's own assessment to inform the appropriate level of Pillar 2A pension obligation risk capital.

2.38 Respondents asked for more clarity on the level of analysis required for increased pension loss near the point of resolution. They proposed that this should be part of firms' recovery and resolution plans.

2.39 The PRA will continue to expect firms to explore this risk as part of their ICAAP in order to allow a holistic review of firms' capital adequacy for pension risk. The analysis should demonstrate a firm's awareness of this tail risk and the adequacy of its mitigating actions. Any mitigating action should be consistent with the firms' recovery and resolution plans.

2.40 Respondents asked whether they could use an accounting or technical provisions (funding deficit) basis for their own assessment of pension risk capital under Pillar 2A. For their own assessments firms should choose methodologies and assumptions that are consistent with their approach to risk management.

2.41 Respondents asked for confirmation as to whether firms with pension fund surpluses should use that as the starting point of the Pillar 2A stress.

2.42 The PRA confirms that surpluses should be the starting point for the stress.

2.43 Respondents asked for clarity on the interaction between Pillar 2A and Pillar 2B stresses for pension obligation risk. They asked to clarify which stress tests — reverse or concurrent — are used to inform Pillar 2B.

2.44 The PRA notes that Pillar 2A and Pillar 2B stresses are independent. Pillar 2B and reverse stress testing are covered in paragraphs 3.13 to 3.21 of SS31/15.

2.45 Respondents asked for confirmation of whether firms will be still allowed to continue to use deferred tax assets (DTA) to offset the Pillar 2A charge for pension obligation risk.

2.46 DTAs related to the projected accounting recognition of pension deficits will no longer be accepted as an offset against Pillar 2A capital for pension obligation risk because of inconsistency with the eligibility criteria in paragraph 8.18 of the statement of policy on Pillar 2. However, there is no intention to claw back any DTA already included in capital resources when setting Pillar 2A.

2.47 One respondent asked for further guidance on the split of the IAS 19[1] discount rate into risk-free and credit-spread components.

(1) http://ec.europa.eu/internal_market/accounting/docs/consolidated/ias_en.pdf.

2.48 The PRA will not provide further guidance on this topic as it is individual firms' responsibility to split these rates. Firms can refer to paragraph 2.25 of SS31/15.

2.49 One respondent noted that the proposed pension risk methodology is UK-specific and it is not clear how firms should approach some of the requirements for their non-UK schemes.

2.50 The PRA refers firms to guidance provided in paragraph 2.28 of SS31/15 and paragraph 8.12 of the statement of policy on Pillar 2.

3 Pillar 2B

The PRA buffer

3.1 The CP proposed key features of the PRA buffer, including transitional arrangements.

3.2 Respondents requested greater transparency on the methodologies used to calculate the PRA buffer. They were particularly interested in the role of the leverage ratio and how the PRA will reflect a firm's systemic importance when setting the PRA buffer.

3.3 The PRA recognises the desire for further clarity. The PRA buffer will be set using supervisory judgement informed by the impact of stress scenarios on a firm's capital requirements and resources, and taking account where appropriate of other factors including leverage and systemic importance. For the largest UK firms, the setting of the PRA buffer will be informed by the Bank's concurrent stress testing. The Bank intends to publish an update of its medium-term vision for stress testing in 2015.

3.4 One respondent suggested that, for some smaller firms, the PRA could recognise the strength of business models by allowing some offset between the Pillar 2A ICG and the capital conservation buffer.

3.5 The PRA disagrees. Pillar 2A and the capital conservation buffer have different purposes. Pillar 2A ICG is for risks that are not adequately captured under Pillar 1 and should be met at all times. The capital conservation buffer is intended to ensure that firms build up capital buffers outside periods of stress which can be drawn down as losses are incurred and thereby avoid firms falling below their minimum requirements in a stress. Article 129(5) of the CRD expressly prohibits double counting of Common Equity Tier 1 (CET1) between Pillar 2A and the capital conservation buffer.

Risk management and governance (RM&G)

3.6 The PRA proposed to apply a scalar to firms' Pillar 1 capital requirement plus Pillar 2A ICG, to be met with CET1 capital, where it assessed management, governance and culture and risk management and controls to be significantly weak.

3.7 Respondents did not believe that capital is a suitable regulatory tool for tackling governance weaknesses. They would like to understand the basis for scalar decisions and how size will be determined. Concern was expressed about the risk of double counting between the scalar and other Pillar 2A requirements, as well as consistency of application. Respondents would also like advance warning of the application of the scalar, to know whether an appeals process exists and clarity on whether the scalar can be removed once failings are addressed (ie in advance of the next Supervisory Review and Evaluation Process (SREP)).

3.8 The PRA agrees that capital does not solve RM&G weaknesses. But given that evidence suggests a link between weak RM&G and firm failure, the PRA continues to consider that the RM&G scalar can help to promote the PRA's safety and soundness objective by ensuring that additional capital is available to absorb the larger losses that are likely to materialise in a stress. As such, it has decided to implement the policy. This approach is also consistent with the EBA SREP guidelines(1) which provide that competent authorities should set additional own funds requirements to cover risks posed by RM&G weaknesses where appropriate as an interim measure, while the deficiencies are addressed.

3.9 The assessment of RM&G is linked closely to the PRA's supervisory assessment of 'risk management and controls' and 'management, governance, and culture' which is set out in *The Prudential Regulation Authority's approach to banking supervision*.(2) A scalar will only be applied when significant weaknesses are identified and the size of the scalar will be proportionate to the extent of the weaknesses identified.

3.10 If an overall RM&G scalar is applied it will be to reflect significant firm-wide RM&G weaknesses. RM&G weaknesses identified in for instance operational risk should not be reflected separately in Pillar 2A ICG for those categories.

3.11 To ensure consistency, RM&G scalar decisions will be subject to a peer review process. As with other risks identified, supervisors will discuss RM&G weaknesses with firms. The RM&G scalar will be subject to the same legal framework as applies to the PRA buffer generally (and currently applies to the capital planning buffer (CPB)), as set out in paragraph 4.24 of SS31/15. The PRA agrees that once the identified weaknesses have been remedied, the scalar should be removed.

(1) www.eba.europa.eu/documents/10180/935249/EBA-GL-2014-13+(Guidelines+on+SREP+methodologies+and+processes).pdf.
(2) *The Prudential Regulation Authority's approach to banking supervision*, June 2014; www.bankofengland.co.uk/publications/Documents/praapproach/bankingappr1406.pdf.

3.12 One respondent asked if the RM&G scalar will be applied to new banking licence applications.

3.13 RM&G is reviewed as part of the authorisation process. This suggests that no automatic scalar should be applied for management and governance simply because the management team and board are new.

Disclosure

3.14 In the CP, the PRA proposed to change its position on the confidentiality of aggregate Pillar 2A ICG from January 2016 and let firms decide whether to disclose their ICG. However, the PRA proposed that it would continue to regard the components of Pillar 2 ICG, as well as the PRA buffer, as confidential unless disclosure is required by law.

3.15 Respondents asked for assurance that the PRA would not prevent disclosure of Pillar 2A components where a firm felt legally obliged to disclose them. One respondent believes that there could be market pressure to disclose Pillar 2B and suggested that the PRA might want to review its proposal to maintain confidentiality of Pillar 2B. It was also suggested that the CP did not take into account all the circumstances that could potentially oblige a firm to disclose Pillar 2A components and Pillar 2B.

3.16 The CP was clear that the PRA is not seeking to prevent firms complying with their market disclosure obligations and that the PRA does not advise firms on their market disclosure obligations. However, the PRA remains of the view that Pillar 2B should otherwise be confidential and firms considering their market disclosure obligations should note that there will be no automatic consequences should a firm use its PRA buffer.

4 Reporting

4.1 The CP included a draft reporting instrument. The new rules will require firms to submit data necessary for the PRA to run the new Pillar 2 methodologies. The rules are included as a stand-alone part of the PRA Rulebook and can be found in Appendix 1 of this policy statement. The data items are mandatory for firms subject to the new rules.

General comments

4.2 Respondents asked for clarification on the data items and instructions.(1) For the credit risk data items firms struggled with the mapping of standardised exposures into the Pillar 2 portfolios. Additionally, a number of firms failed to link the new Pillar 2A data requirements to the new Pillar 2A policies.

4.3 The PRA has provided greater clarity through changes to the rules, the final data items and updated instructions, including giving guidance on mapping credit risk exposures to Pillar 2 portfolios. The PRA also reiterates that the data items and the related instructions should be read in conjunction with the statement of policy on Pillar 2.

Frequency of submissions and scope of population

4.4 Respondents noted that the PRA's proposal to require firms to submit Pillar 2 data with their ICAAP was not clear. They asked for clarity on scope and frequency of additional data that supervisors may ask firms to submit on a case-by-case basis.

4.5 The PRA has clarified in *PRA Supervisory Statement SS32/15*, 'Pillar 2 reporting, including instructions for completing data items FSA071 to FSA082' that Pillar 2 data are needed to assist the SREP. Therefore the PRA has set a requirement that significant firms submit the data at the same time as their ICAAP document and in any event annually. All other firms will be required to submit at the same time as their ICAAP document and in any event on a regular basis that is proportionate to the nature, scale and complexity of the firm's activities. The PRA has clarified that it may request additional reporting from firms on a case-by-case basis. The PRA's expectations have been clarified in SS32/15, the statement of policy on Pillar 2 and in the data item instructions. The PRA has confirmed that firms will be given sufficient notice to comply.

Delayed implementation

4.6 Respondents asked for a later implementation date than 1 January 2016 for submitting data, in particular for operational risk where the quality of firms' data is poor.

4.7 The PRA acknowledges the difficulties in submitting data, but continues to require data submission from 1 January 2016 to avoid delaying the implementation of the new methodologies. The PRA recognises that this will be challenging for some firms and expect that data quality will improve over time. Smaller firms can refer to paragraph 2.19 of SS31/15 which allows for simplified reporting of Pillar 2 data for operational risk.

Overlap with the FDSF data

4.8 Some firms noted a potential overlap with the data covered by the PRA Firms Data Submission Framework (FDSF), particularly for credit, operational and pension risk, and asked the PRA to waive the Pillar 2 reporting requirements where duplication exists.

4.9 In the CP the PRA agreed that firms that submit FDSF data should not be required to submit the same data again for Pillar 2A purposes. The PRA had only identified potential overlap between Pillar 2A and the FDSF data for market risk; it has now aligned the Pillar 2 operational risk reports on historical

(1) Data items and related instructions on Pillar 2 Reporting are available at: www.bankofengland.co.uk/pra/Pages/regulatorydata/formSCRDfirms.aspx.

losses to the FDSF and over time expects a better alignment between Pillar 2 pension risk reports and FDSF. The PRA has therefore amended its data requirements to avoid duplication for operational risk and pension risk. For credit risk there are key differences in the data so the PRA proposes to continue to require firms to submit these data in the relevant data items.

5 Implementation

5.1 The new Pillar 2 framework will come into force from 1 January 2016. 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.

5.2 The PRA will write to all firms before 1 January 2016 to convert their existing CPB into a PRA buffer that offsets against the CRD IV combined buffer. Where firms have an existing Pillar 2A add-on for RM&G, the PRA will relocate this to their PRA buffer and update ICGs accordingly.

Appendices

1 PRA Rulebook CRR Firms: Reporting Pillar 2 Instrument (PRA 2015/61)

2 Supervisory statement 31/15: The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)
(see SS31/15 landing page: www.bankofengland.co.uk/pra/Pages/publications/ss/2015/ss3115.aspx)

3 Statement of Policy: The PRA's methodologies for setting Pillar 2 capital
(see statement of policy landing page: www.bankofengland.co.uk/pra/Pages/publications/sop/2015/p2methodologies.aspx)

4 Supervisory Statement 32/15: Pillar 2 reporting, including instructions for completing data items FSA071 to FSA082
(see SS32/15 landing page: www.bankofengland.co.uk/pra/Pages/publications/ss/2015/ss3215.aspx)

PRA RULEBOOK CRR FIRMS: REPORTING PILLAR 2 INSTRUMENT 2015

Powers exercised

A. The Prudential Regulation Authority ("PRA") makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):

(1) section 137G (The PRA's general rules);and
(2) section 137T (General supplementary powers).

B. The rule-making powers referred to above are specified for the purpose of section 138G(2) (Rule-making instrument) of the Act.

Pre-conditions to making

C. In accordance with section 138J of the Act (Consultation by the PRA), the PRA consulted the Financial Conduct Authority. After consulting, the PRA published a draft of proposed rules and had regard to representations made.

PRA Rulebook CRR Firms: Reporting Pillar 2 Instrument 2015

D. The PRA makes the rules in the Annex to this instrument.

Commencement

E. This instrument comes into force on 1 January 2016.

Citation

F. This instrument may be cited as the CRR Firms: Reporting Pillar 2 Instrument 2015.

By order of the Board of the Prudential Regulation Authority
26 June 2015

Annex

In this Annex, the text is all new and is not underlined.

Part

REPORTING PILLAR 2

Chapter content

1 APPLICATION AND DEFINITIONS

1.1 This Part applies to every *firm* that is a *CRR firm*.

1.2 A *firm* that is neither a *subsidiary* of a *parent undertaking* incorporated in or formed under the law of any part of the *UK* nor a *parent undertaking* must comply with this Part on an individual basis.

1.3 A *firm* that is not a member of a *consolidation group* must comply with this Part on an individual basis.

1.4 A *firm* which is a *parent institution in a Member State* must comply with this Part on a *consolidated basis*.

1.5 A *firm* controlled by a *parent financial holding company in a Member State* or a *parent mixed financial holding company in a Member State* must comply with this Part on the basis of the *consolidated situation* of that holding company, if the *PRA* is responsible for supervision of the *firm* on a *consolidated basis* under Article 111 of the *CRD*.

1.6 In this Part the following definitions shall apply:

Advanced Measurement Approach

means the advanced measurement approach referred to in Article 312(2) of the *CRR*.

consolidation group

means the undertakings included in the scope of consolidation pursuant to Articles 18(1), 18(8), 19(1), 19(3) and 23 of the *CRR* and Groups 2.1 to 2.3.

defined benefit pension scheme

means an *occupational pension scheme* with benefits defined independently of the *firm's* contributions as employer and investment returns.

ICAAP assessment

means a *firm's* written record of the assessments required under Internal Capital Adequacy Assessment.

IRB Approach

has the meaning given in article 143(1) of the *CRR*.

occupational pension scheme

has the meaning given in article 3(1) of the *Regulated Activities Order*.

parent financial holding company in a Member State

means (in accordance with point (26) of Article 3(1) of the *CRD*) a *financial holding company* which is not itself a subsidiary of an *institution* authorised in the same *EEA State*, or of a *financial holding company* or *mixed financial holding company* set up in the same *EEA State*.

parent institution in a Member State

means (in accordance with point (24) of Article 3(1) of the *CRD*) an *institution* authorised in an *EEA State* which has an *institution* or *financial institution* as *subsidiary* or which holds a *participation* in such an *institution* or *financial institution* and which is not itself a *subsidiary* of another *institution* authorised in the same *EEA State* or of a *financial holding company* or *mixed financial holding company* set up in the same *EEA State*.

parent mixed financial holding company in a Member State

means (in accordance with point (28) of Article 3(1) of the *CRD*) a *mixed financial holding company* which is not itself a subsidiary of an *institution* authorised in the same *EEA State*, or of a *financial holding company* or *mixed financial holding company* set up in the same *EEA State*.

2 PILLAR 2 REPORTING REQUIREMENTS

2.1 A *firm* must complete the *data item* FSA071 for the risk assessments required in the ICAA Part.

2.2 A *firm* must complete the *data items* FSA078 and FSA079 for concentration risk.

2.3 A significant *firm* and any *firm* that is not significant but that has permission from the *PRA* to use the *Advanced Measurement Approach* must complete the *data items* FSA072, FSA073, FSA074 and FSA075 for operational risk, unless the data required in that *data item* has already been reported to the *PRA* by other means.

2.4 A *firm* with significant illiquid risk in its trading book must complete the *data item* FSA080 for market risk, unless the data required in that *data item* has already been reported to the *PRA* by other means.

2.5 A *firm* with permission from the *PRA* to use the *IRB Approach* for retail claims or contingent retail claims must complete the *data item* FSA082 for credit risk that relates to the *IRB Approach* for retail exposures.

2.6 A *firm* with a *defined benefit pension scheme* must complete the *data item* FSA081 for pension obligation risk, unless the data required in that *data item* has already been reported to the *PRA* by other means.

3 SUBMISSION

3.1 A *firm* must submit the *data items* it is required to complete by this Part to the *PRA* at the same time as the *firm* submits its *ICAAP assessment* to the *PRA*.

3.2 If a *firm* does not submit an *ICAAP assessment* to the *PRA* on an annual basis:

(1) a significant *firm* must submit the *data items* it is required to complete by this Part to the *PRA* on an annual basis;

(2) a *firm* that is not significant but that has permission from the *PRA* to use the *Advanced Measurement Approach* must submit the *data items* it is required to complete by *rule* 2.3 to the *PRA* on an annual basis; and

(3) a *firm* that is not significant must submit the *data items* it is required to complete by this Part to the *PRA* on a regular basis that is proportionate to the nature, scale and complexity of the *firm's* activities.

3.3 *Data items* must be submitted to the *PRA* by electronic means.

3.4 When submitting the required *data item*, a *firm* must use the template for the *data item* set out in Chapter 4.

4 DATA ITEMS

4.1 FSA071 can be found here.

4.2 FSA072 can be found here.

4.3 FSA073 can be found here.

4.4 FSA074 can be found here.

4.5 FSA075 can be found here.

4.6 FSA078 can be found here.

4.7 FSA079 can be found here.

4.8 FSA080 can be found here.

4.9 FSA081 can be found here.

4.10 FSA082 can be found here.

REGULATORY REPORTING

Externally defined glossary terms

Term	Definition source
consolidated basis	*Article 4(1)(48) CRR*
consolidated situation	*Article 4(1)(47) CRR*
EEA State	*s425 FSMA*
financial institution	*Article 4(1)(26) CRR*
financial holding company	*Article 4(1)(20) CRR*
institution	*Article 4(1)(3) CRR*
mixed financial holding company	*Article 4(1)(21) CRR*
parent undertaking	*Article 4(1)(15) CRR*
participation	*Article 4(1)(35) CRR*
subsidiary	*Article 4(1)(16) CRR*