Financial Conduct Authority

CRD IV Pillar 2 Summary and Stress Testing Observations

September 2016

1. CRDIV Pillar 2 summary

1.1 From 1 January 2016 the FCA has complied with the EBA's Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP) (GLs) when undertaking a SREP for entities subject to CRDIV.

Background

1.2 This document summarises some aspects of existing Pillar 2 policy arising from CRD IV and, specifically, as a consequence of the publication of the GLs. None of the following constitutes a change in FCA policy; these examples are to assist in understanding existing Pillar 2 policy in the context of CRD IV.

1.3 We recognise that the revised capital adequacy framework set out by CRD IV enhances the conditions for the quality of own funds and stress-testing requirements and we wish to provide a summary of them to enable firms, many of them small, to better understand them.

1.4 In addition to revising the framework for capital requirements, including capital buffers, CRD IV introduced more stringent conditions on the quality of own funds that IFPRU firms are required to hold in order to meet those own fund requirements. To illustrate this we provide examples of the respective overall capital requirement in terms of how the following components of the own fund requirements fit together and the quality of own funds that are required to meet them.

1.5 The areas under Pillar 2 of particular focus for IFPRU firms are as follows:

- The calculation of capital requirements according to the 'Pillar 1 plus' approach required of the FCA by the GLs. (This approach is outlined in the section relating to own fund requirements.)
- The determination of the quantity and quality of own funds that firms should hold to meet the various requirements that arise from the ICAAP and SREP in the context of CRD IV.

1.6 We intend to communicate to firms via Individual Capital Guidance (ICG), the quantity and quality of own funds following the SREP under new requirements that were implemented from 1 January 2016. This will cover Pillar 1, Pillar 2, the Capital Planning Buffer and any CRD IV combined buffer requirements.

1.7 The Internal Capital Adequacy Assessment **Process** (ICAAP):

- **is not** a document produced annually;
- **it is:**
  - the firm's embedded risk management process;

– which is evidenced and supported by the firm's appropriate ICAAP/risk management framework ; including policies, procedures, systems and controls, in order to manage risk on an ongoing basis (as appropriate and in a proportionate way).

Firms should carry out assessments described in IFPRU 2.2.7R (Strategy processes and systems) at least annually or more frequently as indicated in IFPRU 2.2.16G (e.g. the ICAAP Review Document). This assessment must be formally documented as indicated in IFPRU 2.2.43R.

1.8 When undertaking a SREP we may ask a firm to provide copies of its firm's ICAAP policies, procedures, systems and controls, evidence of the risk management process in action (e.g. minutes evidencing identification and escalation of risk the firm is subject to) and a copy of the firm's most recent assessment of the adequacy of its ICAAP (ICAAP Review Document.)

Own fund requirements

1.9 The own fund requirements are those specified under:

- Pillar 1 (i.e. the minimum own funds requirement at the level of each individual risk type; credit, market and where applicable at Pillar 1, operational); and
- Pillar 2 (i.e. the requirement on firms to have systems and controls to ensure they hold sufficient own funds greater than Pillar 1.) This includes the FCA's individual capital guidance to the firm relating to the amount and quality of capital which it should hold to meet the overall financial adequacy rule (IFPRU 2.2.1R)[1] and overall liquidity adequacy rule (BIPRU 12.2.1R. It also includes how the capital-planning buffer works alongside the combination of Pillar 1, ICG and the CRD IV buffers.

1.10 The obligation on firms to maintain sufficient own funds to meet the requirements which comprises a number of components and steps leading to the determination of the final own funds requirements: some of those steps being undertaken by a firm, some by the FCA.

- Pillar 1 – the minimum own funds requirement at the level of each individual risk type (credit, market and where applicable at Pillar 1, operational), calculated by the firm.
  - The Fixed Overhead Requirement, whilst not being a risk category, applies where operational risk does not for Limited Licence and Limited Activity firms, but is not a Pillar 2 Risk.
- Pillar 2 ICAAP and SREP – an assessment of risks not covered adequately or at all (e.g. pension risk or interest rate risk in the non-trading book, in the event these apply) under Pillar 1 and the associated own fund requirements. There are two stages: the ICAAP undertaken by the firm and the SREP[2] undertaken by the FCA, i.e. an assessment of the firm's ICAAP. Pillar 2 also encompasses a forward-looking assessment of the risks that a firm might be subject to in periods of stress, resulting in the determination of a capital-planning buffer (where applicable). The FCA may communicate a capital planning buffer to Limited Licence Firms, but generally does not do so.

1 BIPRU 12 contains rules and guidance relating to the adequacy of a firm's liquidity resources. In assessing the adequacy of its liquidity resources, a firm should do so by reference to the overall liquidity adequacy rule, rather than the overall financial adequacy rule.

2 The FCA also assesses the adequacy of the firm's management, governance and culture through the SREP, in addition to that undertaken through the usual supervisory process.

- This leads to the third element of the SREP, the giving of Individual Capital Guidance to a firm (ICG). This is guidance of the FCA's view of the financial resources that the firm should hold and its governance, systems and controls in order to ensure there is no significant risk that its liabilities cannot be met as they fall due.[3] The ICG given may be supplemented by capital planning buffer to ensure that the firm can meet the overall financial adequacy rule in future periods of stress; this capital-planning buffer will take account of those risks which are not met by the combined buffer for firms where this requirement also applies.

The Individual Capital Adequacy Assessment Process

What does Pillar 1 plus include?

1.11 The GLs specify that when undertaking the SREP for firms subject to CRD IV, the FCA should adopt a Pillar 1 plus approach in assessing capital requirements under Pillar 2 and here we summarise what this approach comprises of.

1.12 Under Pillar 1-plus, for the same risk categories being covered at Pillar 2, the amount that the Pillar 2 risk amounts to, on a risk-by-risk category basis, can be no less than that at Pillar 1. Therefore, if credit risk at Pillar 2 is less than that at Pillar 1, Pillar 2 credit risk is at least the amount at Pillar 1; it may not be less.

1.13 In the event that a Pillar 1 risk is assessed as being greater at Pillar 2, then the amount in addition to Pillar 1 is added, at Pillar 2, to the Pillar 1 minimum. Figure 2 below shows that the Pillar 1 credit risk (orange block) is increased by the additional Pillar 2 credit risk (dark grey block).

1.14 For those Pillar 2 risks which do not form part of Pillar 1, these are additional to Pillar 1 (and any Pillar 2 level of own funds attributed to Pillar 1 risks), as shown in Figure 2 below. For example, the amount attributed by way of the Pillar 2 interest rate risk in the non-trading book, which is not a Pillar 1 risk, (violet) is added to the Pillar 2 stack.

Own funds – quality required and capital ratios

1.15 Given the Pillar 1 plus approach to calculating capital requirements, we now provide examples on own funds requirements under CRD IV.

1.16 Figure 2 shows a Full Scope IFPRU Investment Firm example with each stack of capital.

- It shows the Pillar 1 stack as the minimum own funds requirement, which comprises credit/counterparty risk, market risk and operational risk requirements calculated in accordance with CRR.

- The second stack shows the combination of the firm's assessment of the level of own funds requirement, showing the additional amount of credit, market and operational risk in addition to the Pillar 1 amounts, plus the assessment attributed to Pillar 2 risk types that do not fall under Pillar 1 (e.g. pension risk).

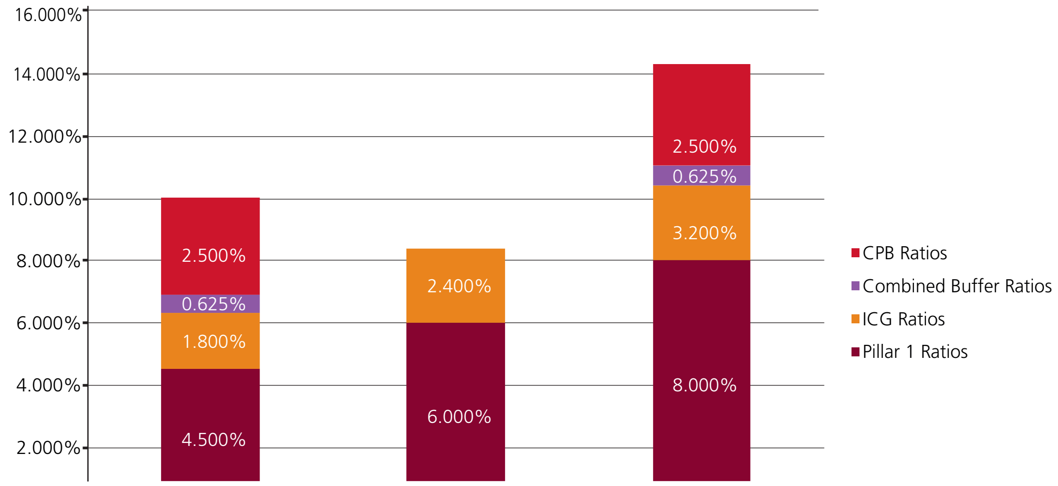
- The third stack shows an example of the FCA's additional capital assessment. Depending on the level of own funds agreed between the FCA and the firm, this will then be expressed in the ICG as additional Capital Ratios that the FCA will issue on completion of the SREP.

3 IFPRU 2.2.1 R is the overall financial adequacy rule.

- In addition, the fourth stack represents the combined buffer (the CRD IV buffers which apply to certain IFPRU firms), and the fifth stack shows the capital planning buffer net of risks also met by the combined buffer: i.e. the total buffer applicable is the higher of the combined buffer and the capital planning buffer.

- Figure 1 shows an example of how this same full scope firm, with the level of own funds shown in Figure 2, might be required to meet its Pillar 1 (maroon block), Pillar 2 (orange block), combined buffer (Capital Conservation Buffer only), at the 2016 transitional amount (violet block) and capital planning buffers (red block) in terms of quantity and quality of own funds and expressed as additional Capital Ratios.

1.17 Figure 1 - Minimum Captial Ratios



1.18 In Fig.1, the firm will need to monitor three ratios:

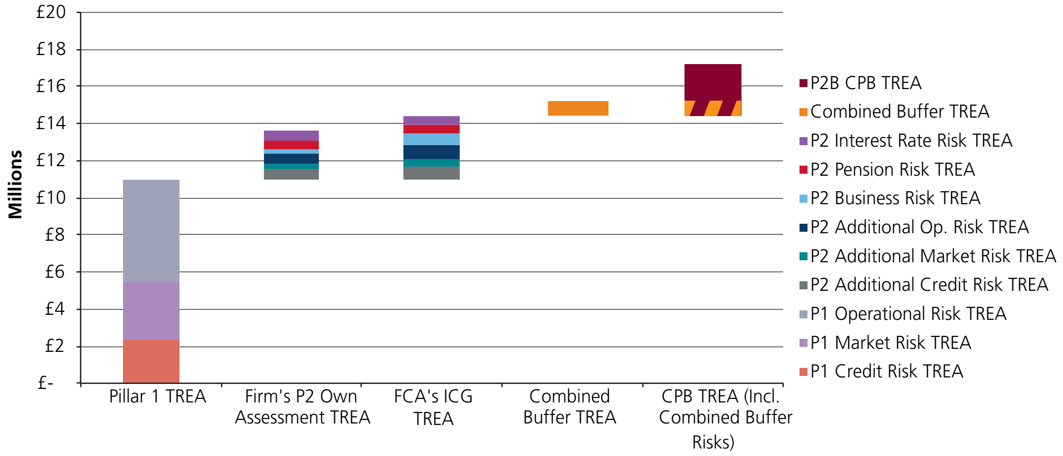
- its CET1 ratio;
- its total tier 1 ratio; and
- its total own funds ratio.

1.19 In the Fig.1 example, the FCA has given ICG and set a capital planning buffer for the firm. This incorporates the requirement for the firm to meet its ICG level of own funds (P2A) with at least 56% in CET1, 75% in total tier 1 and, as CRD IV requires, meet its combined buffer exclusively with CET1, which is not used to meet another CET1 requirement. Therefore, in this example, this firm will need to ensure its CET1 is always at least 9.425% of TREA, total tier 1 is always at least 8.400% of TREA (in this example this means that the firm always maintain 9.425% of TREA because that is the minimum CET1 ratio) and total own funds is always at least 14.325% of TREA.

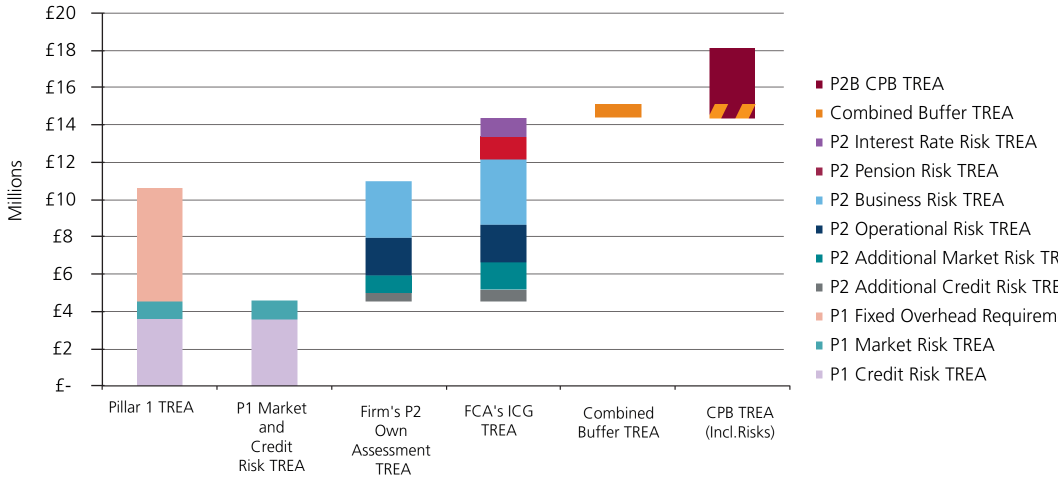
Examples of Capital Requirements for IFPRU firms – Full Scope, Limited Activity and Limited Licence

1.20 In Figures 2, 3 and 4 we respectively show examples of how the capital requirements for full scope, limited activity and limited licence IFPRU firms are determined.[4] These are based on the calculation, moving from left to right, of Pillar 1 capital requirements arising from CRR, Pillar 2 showing the firm's own ICAAP assessment and the outcome of the FCA's SREP of that ICAAP assessment, the Combined Buffer requirement (if it applies) and the Capital Planning Buffer (where one is set).

1.21 Figure 2 – Full scope firm Total Risk Exposure Amounts (TREA).

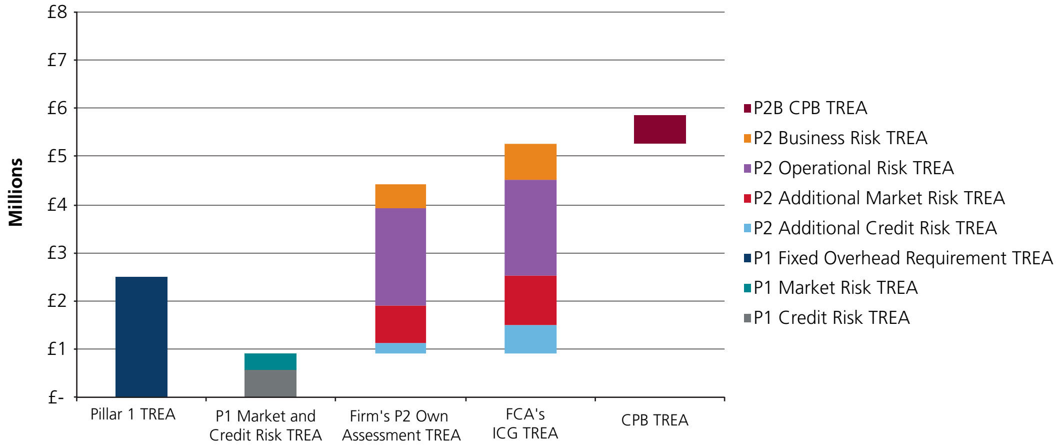


1.22 Figure 3 – Limited activity firm TREA



4 Refer to IFPRU 1.1 and PERG 13.6 for guidance on the classification of IFPRU investment firms i.e. full-scope IFPRU investment firm, IFPRU limited licence firm, IFPRU limited activity firm; or on the basis of the base own funds requirements as IFPRU 50K firm, IFPRU 125K firm or IFPRU 730K firm.

1.23 Figure 4 – Limited licence firm TREA (the combined buffer does not apply to these firms)



Example Supervisory Intervention Points for IFPRU firms

1.24 Figure 1 also demonstrates the FCA's supervisory intervention points in a way that is progressively more significant. Taking the CET1 ratio by way of example (although the other ratios, total tier1 and total own funds also hold similar intervention thresholds), in the event that the firm were to hold CET1 below each of the thresholds shown:

Intervention's increasing significance	Total CET1 Ratio intervention thresholds <	Supervisory intervention
	9.425%	This will initiate the obligations on the firm to notify the FCA it has dipped into its capital-planning buffer, explaining why and what plans the firm has to rectify the situation.
	6.925%	At and below this point the provisions on restrictions on distributions (including on Maximum Distributable Amount) apply.
	6.300%	This will instigate enhanced supervisory oversight.
	4.500%	This would constitute a breach in the firm's Minimum Capital Requirement.

1.25 Figure 1 also demonstrates the Overall Capital Requirement supervisory intervention points as a firm's Total Own Funds diminish.

Intervention's increasing significance	Total Own Funds Ratio intervention thresholds <	Supervisory intervention
	14.325%	This will initiate the obligations on the firm to notify the FCA it has dipped into its capital-planning buffer, explaining why and what plans the firm has to rectify the situation.
	11.825%	At and below this point the provisions on restrictions on distributions (including on Maximum Distributable Amount) apply.
	11.200%	This will instigate enhanced supervisory oversight.
	8.000%	This would constitute a breach in the firm's Minimum Capital Requirement.

2. Stress testing – observations

2.1 In this section, we lay out observations that stem from the stress and scenario testing reports received from significant IFPRU investment firms since 1 January 2014. These might also be of equal interest to all IFPRU firms.

Background

2.2 Under the current provisions (IFPRU 2.2.36R and 2.2.37R), a significant IFPRU firm is required annually to submit to the FCA its results of the stress tests and scenario analysis. Having reviewed the stress-testing reports since these provisions came into force on 1 January 2014, the FCA is disappointed with the level of compliance with this stress-testing rule, both by the number of reports submitted on time and by their quality. Many did not contain all of the required basic elements listed throughout IFPRU 2.2. By way of example, firms need to show the results of stress tests and scenarios which did not put the firm under any stress as well as those which do.

2.3 Additionally, firms themselves have raised queries in relation to how they should perform appropriate stress testing. We have collated examples of stress-testing exercises undertaken by firms, and examples of these are included below. Doing this will help firms' understanding of this topic and assist them when they undertake their stress-testing exercises.

2.4 In accordance with the requirements (IFPRU 2.2), a stress-testing report should contain an assessment of all risks that the firm is exposed to. This risk analysis should subsequently inform the creation and selection of stress-testing scenarios, because these scenarios need to be based on stressing those risks that are relevant to the firm. The analysis should also inform the reverse stress testing, as these risks may push a firm or business plan to become no longer viable. The stress-testing report and the risks identified form an integral part of the planning and strategy of the firm.

Observations of stress-testing submissions

2.5 Based on reports received since the relevant IFPRU requirements came into force, we have observed the following issues.

- A common problem with reports received is that they do not contain an assessment of all the risks that a firm might be subject to, irrespective of whether they are material or otherwise. If the full identification and subsequent analysis is not shown the choice of stress test scenarios appear arbitrary which then leads to inappropriate identification of suitable stress scenarios for the firm.

- Base case assumptions are optimistic with respect to the firm's current financial position and growth projections which subsequently reduces the impact of the stress.

- The quality of the stress tests conducted was often below the necessary standard. For example, a common problem observed was that the impact on profit and loss and financial resources was not measured. This reduces the information value and use test of the report.

- Liquidity, a key element of firm's financial resources, has not been considered appropriately under any scenario.

- It is often clear from the way the report is written that its purpose is to satisfy the reporting requirement rather than to form an integral part of the firm's decision making and strategy. This defeats the objectives of the report and its use test and could indicate a serious internal governance issue.

- A common problem is that the reports received are, in part or in total, the ICAAP adequacy review document. Although there is commonality between reports drafted for these separate requirements, the stress-testing report, in this context, is a self-standing complete document that must satisfy all of its related requirements. It is not necessary to submit a copy of the current complete ICAAP adequacy review document. Supporting information is insufficient; firms are not detailing their assumptions and calculations including qualitative descriptions of the scenarios modelled. In some instances it cannot be determined whether the scenario analysis includes mitigating actions.

- The reverse stress test (RST) is poorly understood by firms. The exercise is often treated as a timeline to show at which point the firm would choose to wind-down during a stressed period. RST is a scenario from which the firm cannot recover.

- Management/mitigation actions: some firms detail what actions would be taken, the impact, timing and plausibility of those actions and the rationale behind them. They also clarify how the firm would fare before and after management actions are taken.

- 12 Month Horizon: some firms assess the impact of Pillar 2 risks (Pillar 1 Risks plus Risks not covered or adequatly covered at Pillar 1, on the Pillar 1 Plus approach) which might materialise in the next 12 months (typically from the ICAAP Reference Date, e.g. the firm's Financial Reference Date.)

- 3 to 5 Year Horizon: some firms present a Business as Usual capital planning projection (as a Base Line) which takes account of the firm's business plan and strategy. These sometimes include more than one Base Line to take account of different plans and time scales that might apply (e.g. the firm think that they will acquire a new business, develop a new product and/or service line requiring additional expenditure and revised risk impact.) Scenario and stress testing is applied to these Base Line assumptions, such as what happens if the new line of business is not as successful as they thought, then to stress that even more to where the firm suffers losses (i.e. a severe but plausible stressed event), what if the risk are greater than they thought, what if the market does not behave as expected etc.

2.6 This is not an exclusive list of problems encountered, nor is it minimum list of requirements the report should satisfy. However, it is hoped that these examples assist in improving the overall quality of reports submitted.

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