

09/30***

Financial Services Authority

Capital planning buffers

December 2009

Contents

1	Overview	3
2	Market failure analysis, summary CBA and context for proposed changes	8
3	Underpinnings of capital planning buffers	11
4	Setting and using capital planning buffers	15
5	Specifying ICG or CPB in particular forms of capital	21
6	Other issues	23

Annex 1: Summary list of consultation questions

Annex 2: Example of the calculation of the capital planning buffer

Annex 3: Compatibility with our objectives and the principles of good regulation

Annex 4: List of acronyms

Appendix 1: Draft Handbook text

The Financial Services Authority invites comments on this Consultation Paper. Comments should reach us by 31 March 2010.

Comments may be sent by electronic submission using the form on the FSA's website at (www.fsa.gov.uk/Pages/Library/Policy/CP/2009/cp09_30_response.shtml).

Alternatively, please send comments in writing to:

Piers Haben
Pillar 2 & Stress Testing Policy
Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

Telephone: 020 7066 8198
Fax: 020 7066 8199
E-mail: cp09_30@fsa.gov.uk

It is the FSA's policy to make all responses to formal consultation available for public inspection unless the respondent requests otherwise. A standard confidentiality statement in an e-mail message will not be regarded as a request for non-disclosure.

A confidential response may be requested from us under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Tribunal.

Copies of this Consultation Paper are available to download from our website – www.fsa.gov.uk. Alternatively, paper copies can be obtained by calling the FSA order line: 0845 608 2372.

1 Overview

Introduction

- 1.1 The FSA's integrated approach to stress testing consists of three main elements:
- **Firms' own stress testing.** We expect firms to develop, implement and action a robust and effective stress testing programme which assesses their ability to meet capital and liquidity requirements in stressed conditions, as a key component of effective risk management;
 - **FSA stress testing of specific firms.** The FSA runs its own stress tests on a periodic basis for a number of firms. We do this regularly for specific high impact firms and on other firms as the need arises, to assess their ability to meet minimum specified capital levels¹ throughout a stress period.
 - **Simultaneous system-wide stress testing** undertaken by firms using a common scenario for financial stability purposes.
- 1.2 These three elements are interlinked and mutually reinforcing. This CP deals primarily with firms' own stress testing, the first element above.
- 1.3 In CP08/24 we proposed specific measures to improve stress testing in firms. We have followed CP08/24 with a Policy Statement (PS09/20) that strengthens our requirements on firms' stress testing by setting out good practice in creating an effective stress testing infrastructure, setting out expectations for the appropriate severity of Pillar 2 stress scenarios and introducing reverse stress-testing requirements where firms are required to identify scenarios that lead to business failure.

1 For banks this includes all relevant capital ratios in the in the supervisory framework including individual capital guidance (ICG) and other relevant ratios:
<http://www.fsa.gov.uk/pages/Library/Communication/Statements/2008/capapp.shtml>
http://www.fsa.gov.uk/pages/Library/Communication/Statements/2009/bank_capital_.shtml

- 1.4 Respondents to CP08/24 generally understood our proposals, but some sought more information on the capital planning stress test under Pillar 2. In particular, in relation to CP08/24 question 10, which asked BIPRU firms ‘do you have any comments on our requirements that in general firms should hold capital now against the overall financial adequacy rule, including in a stress scenario after allowing for realistic management actions?’, respondents asked us to be clearer on:
- a. the appropriate severity of scenarios used for capital planning;
 - b. the purpose of the CPB² and how it would be used up in adverse external circumstances, such as severe macroeconomic downturns, financial/market shocks or other adverse external events; and
 - c. how the calculation of the CPB fits with the various capital ratios that supervisors monitor firms against, and whether supervisors should ask firms to hold elements of the CPB in specific forms of capital.
- 1.5 These questions relate to the changes we have made to BIPRU 2.2 as described in our Policy Statement (PS09/20).
- 1.6 In PS09/20, we explain the type of severity we expect to see in Pillar 2 stress tests and how we see the role of supervisory recommended scenarios. That is, we expect firms to develop a range of scenarios relevant to their risk profile, including a severe economic downturn based on forward-looking hypothetical events that are calibrated against the most adverse movements in individual risk drivers experienced over a long historical period. In future we expect that the severity of stress scenarios and the credibility of management actions will be better informed by recent experience. We will also publish supervisory recommended scenarios in the future and expect firms to use these as an adverse ‘anchor’ scenario in developing their own scenarios. Some firms will also, at times, be asked to run specific scenarios that should be included in ICAAP³ submissions.
- 1.7 However, to respond appropriately to questions identified in subparagraphs 1.4b and 1.4c above regarding the CPB, this Consultation Paper (CP) proposes further minor Handbook changes for BIPRU firms.
- 1.8 These changes clarify our approach to setting capital planning buffers. The (CPB) is not a new regulatory requirement and is currently set under Pillar 2 for BIPRU firms. We set the buffer by asking firms to undertake a stress test and analyse movements in capital resources and requirements in the stress. This is currently articulated as a sum that should be held for capital planning purposes as part of total ICG.⁴ In this CP, we refer to the CPB as the amount of capital that should be held now, so that it is available to absorb losses and meet higher capital requirements during adverse external circumstances after allowing for realistic management actions. It is designed to help a firm to meet our minimum specified levels of capital in stressed conditions.

2 We have previously identified the capital requirement in relation to capital planning as part of a firm’s general individual capital guidance. For ease of reference throughout this text we will refer to this as a capital planning buffer (CPB).

3 Internal capital adequacy assessment process.

4 For example, set in relation to the Capital Resources Requirement (CRR), $ICG = X\%$ of CRR (to capture, for example, concentration risk and interest rate risk in the non-trading book) + £Ym (capital planning).

- 1.9 Recent experience and the feedback we received in response to CP08/24, suggested that firms did not understand that the capital planning element, currently set as part of total ICG under the supervisory review and evaluation process (SREP), is actually available to be drawn down during adverse external circumstances. It is in this context that we are suggesting some minor Handbook changes to clarify our approach.

Purpose of this Consultation Paper

- 1.10 The proposed changes to the Handbook are designed to help firms, and their auditors, understand that the CPB is available to absorb losses and increased capital requirements in adverse external circumstances. Specifically, we intend to simplify the mechanism for using this buffer.
- 1.11 We also clarify that the CPB should be set at a level that enables a firm to meet all relevant capital ratios in the supervisory framework at all points in the economic cycle. To that end, we clarify our view that we may, at times, specify that elements of a CPB, or elements of ICG, should be held in particular forms of capital as required on a case-by-case basis.
- 1.12 We believe that this does not represent a change in policy but rather a clarification that is best reflected in a Handbook change. Our current Handbook text already allows the CPB to be drawn down in a stress and allows us to specify that elements of ICG should be held in particular forms of capital. However, to clarify our approach we intend to amend the Handbook to make this more explicit. Also, this CP does not introduce new rules regarding minimum capital requirements. Discussions on new capital standards are ongoing nationally and internationally.⁵ Where we reference our existing regime (including frameworks that we have asked firms to monitor against¹), we do this simply to make our current framework clearer to firms.

Policy proposals

- 1.13 The proposed Handbook changes are designed to clarify our intention that:
- The CPB, set as part of our supervisory review under Pillar 2, can be drawn down in adverse external circumstances. To that end we intend to break the link between the CPB and our financial adequacy rule (GENPRU 1.2.26R). This will be identified in BIPRU 2.2; and
 - We may, at times, specify that elements of the CPB, or ICG, should be held in particular forms of capital. We will achieve this by amendments to BIPRU 2.2.
- 1.14 We also make clear that if a firm chose not to hold the CPB at the time when it was set, or if the CPB were drawn down for purposes that were clearly unrelated to adverse external circumstances (such as an acquisition), there are a range of actions that the FSA may take. As an initial step, we would engage with senior management to understand their reasons for not holding the CPB. If we and a firm's senior

⁵ See recent press statement from the Bank for International Settlements (<http://www.bis.org/press/p090907.htm>).

management disagreed significantly on this, we may consider remedial actions which could, in extremis, include variations of permission. However, we do see variations of permission as a last resort that would only be used in the event of a breakdown in dialogue between the firm and its supervisor.

Questions

- 1.15 We are asking for responses to some questions, which are set out in relevant sections and are summarised in Annex 1.

Who should read this paper?

- 1.16 This paper will be of primary interest to banks, building societies and CRD investment firms. Members of board risk committees (in particular those who are non-executive directors), senior management and chief risk officers, as individuals responsible for implementing and overseeing capital planning within a firm, should read this paper to understand what is expected of them. A wide range of other staff in these firms should also read this paper.

Consumers

This paper is important for consumers because our prudential requirements for BIPRU firms are a means of achieving our consumer protection objective and changes to these requirements therefore have potential impact on consumers. Firms are required to assess the adequacy of financial resources and make contingency plans against potential adverse circumstances.

Scope

- 1.17 The proposals in this CP are, in general, aimed at BIPRU firms including banks, building societies and CRD investment firms as relevant.⁶ However, we intend to apply the principle of proportionality to implementation of these proposals. We already apply proportionality more broadly under our Pillar 2 regime as reflected in provisions in BIPRU 2.2.13. So, it may be the case that some very small firms are not set capital planning buffers now and no change in this policy is expected.
- 1.18 Insurers are excluded from these requirements as the Pillar 2 regime for insurers is different to that for BIPRU firms and the same market failures do not apply. Insurers are required to assess a Pillar 2 ICA comparable to a 99.5% confidence level over a 12-month horizon where the value of assets exceeds the value of liabilities, in the context of a realistic and market-consistent balance sheet that is prepared for this purpose. We do expect insurers to undertake capital planning and we have set out in Annex 4 in PS09/20 an explanation of how we expect insurers to undertake relevant stress and scenario testing along with associated capital planning to show how they would propose to maintain an adequate financial position.

⁶ In the case of UK firms within European groups, under article 129 of the CRD there will be an increasing move towards a common approach to ICG with other group supervisors.

- 1.19 Accordingly, most of the proposed rule changes in this CP apply to BIPRU or to the interaction between GENPRU and BIPRU.

Structure of this paper

- 1.20 We have set this paper out as follows:
- Section 2 – Market failure analysis, summary cost-benefit analysis (CBA) and context for proposed changes;
 - Section 3 – Underpinnings of capital planning buffers;
 - Section 4 – Setting and using capital planning buffers;
 - Section 5 – Specifying ICG or CPB in particular forms of capital;
 - Section 6 – Other issues;
 - Annex 1 – Summary list of consultation questions;
 - Annex 2 – Example of the calculation of the capital planning buffer;
 - Annex 3 – Compatibility with our objectives and the principles of good regulation;
 - Annex 4 – List of acronyms; and
 - Appendix 1 – Draft Handbook text

Next steps

- 1.21 We invite responses to the questions raised in this consultation by 31 March 2010. Following our review of feedback received, our intention is to publish a Policy Statement in the third quarter of 2010, setting out the finalised Handbook changes.

2 Market failure analysis, summary CBA and context for proposed changes

Introduction

- 2.1 We have committed to undertaking market failure analysis (MFA) and cost-benefit analysis (CBA) for all Handbook changes to help ensure that regulatory intervention addresses market failures and delivers a net overall benefit, taking into account costs and benefits to all relevant stakeholders.
- 2.2 The general economic rationale for prudential regulation was explored in Occasional Paper Series 1.⁷ In addition to systemic considerations the paper notes that ‘there is a case for prudential regulation of financial firms when:
- the institution performs a fiduciary role;
 - consumers are unable to judge the safety and soundness of institutions at the time purchases or contracts are made;
 - post-contract behaviour determines the value of contracts, and when the institution may become more risky because of a change in its behaviour after a long-term contract has been taken out by consumers; and
 - there is a potential claim on an insurance fund or compensation scheme because the costs of hazardous behaviour of an individual financial firm can be passed on to others (those who in the end pay financial compensation). If, for instance, other firms in the industry are required to pay the compensation liabilities of failed institutions (as in the UK) it would be reasonable for these firms to demand certain minimum standards of behaviour which they are unable to enforce themselves without an external agency’s intervention.’
- 2.3 In CP08/24, we explained the reasons why we expect firms to undertake effective stress testing. Stress and scenario testing is an important tool for firms’ prudential risk management. In particular, it can be useful to a firm’s senior management decision-making by:

⁷ This noted that: ‘regulation for systemic reasons is warranted when the social costs of failure of financial institutions exceed private costs and such potential costs are not incorporated in the decision-making of firms. Firms may, therefore, be induced into more risky behaviour than they would if all risks (including those for the system as a whole) were incorporated in their pricing’.

⁸ CP09/30: Capital planning buffers (December 2009)

- enabling them better to shape the risk profile of the firm through a better understanding of the risks to which it is exposed;
- helping to provide a more forward-looking assessment of risk, as a complement to other risk management tools, and helping to overcome the limitations of reliance on historical data;
- helping to evaluate the impact of extreme events which may result in significant losses;
- helping to identify risk concentrations across multiple business lines or units;
- enabling them better to integrate business strategy, risk management and capital planning decisions; and
- providing a framework which supports a firm's internal and external communication.

2.4 One objective of Pillar 2 stress testing in particular is to better identify how capital resources and requirements would move in times of stress. We may, at times, require firms to hold capital planning buffers now such that, even during times of adverse external circumstances, firms can continue to meet their minimum capital requirements.

2.5 However, any uncertainty as to how or why the CPB can be drawn down during adverse external circumstances may create inefficiencies that impede the objectives of effective prudential regulation.

2.6 In addition, if capital requirements are to be effective and serve their intended purpose it is important that supervisors can set elements of ICG or CPB against a specific quality of capital that is relevant for the objective. Specifying that elements of ICG or CPB should be held in particular forms of capital, where relevant, will ensure that capital serves its specific purpose.

Summary cost-benefit analysis

2.7 The proposed Handbook changes outlined in this CP are designed to clarify our policy, but not introduce new requirements. We believe the changes outlined here do not give rise to incremental costs compared to the changes not being made, since these are clarifications of current requirements, which firms must comply with even if the proposed changes are not made. It is also our view that the benefits that greater clarity brings will apply to all relevant stakeholders.

2.8 The clarity that we are providing on the use of the CPB and ICG, and breaking the link with GENPRU 1.2.26R, may also reduce costs resulting from uncertainty for firms in discussing the potential use of the CPB with their board and their auditors.

2.9 Our clarification that at times we may specify that elements of the CPB or ICG should be held in particular forms of capital is intended purely to improve communication about existing practice. It is neither the intention of this CP to introduce new qualities of capital nor to introduce new capital ratios to which firms must adhere. In this CP we reference existing regulatory capital ratios by way of example, including those that we have publicly identified as being relevant for specific firms¹. We have not attempted to foreshadow any other capital frameworks

which may be introduced and note that work on identifying relevant capital ratios is being undertaken elsewhere. This CP merely clarifies the transmission mechanism through which supervisors may specify that elements of ICG or CPB should be held in particular forms of capital.

Q1: Do you agree with our market failure analysis and our summary cost-benefit analysis?

3 Underpinnings of capital planning buffers

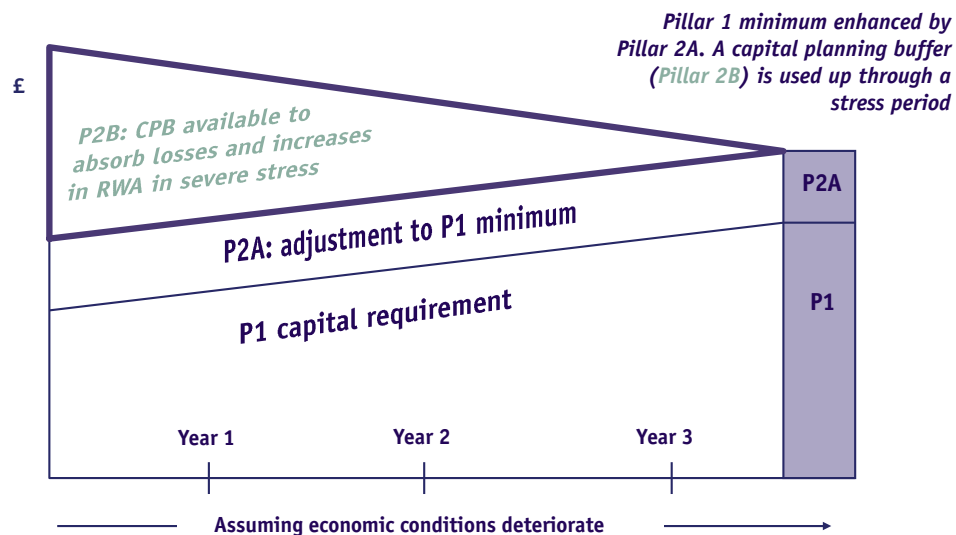
- 3.1 Pillar 2 is one of three ‘supervisory pillars’ that form the prudential framework for supervision of banks, credit institutions, investment firms and insurers. Within the overall framework, Pillar 2 specifically requires firms to assess the amount of capital they consider adequate to cover all of the risks to which they are, or may reasonably be foreseen to be, exposed.
- 3.2 The supervisory review and evaluation process (SREP) of Pillar 2 is the FSA supervisors’ general review of firms’ risk management and prudential soundness. A key element of Pillar 2 and the supervisory review process is a capital planning stress test to understand how changes in the external environment will affect firms’ ability to meet their capital needs, including minimum regulatory capital requirements, on a forward-looking basis. In CP08/24 we outlined our intentions to clarify that to comply with the overall Pillar 2 rule (GENPRU 1.2.30R) firms should satisfy the general stress testing requirement set out in GENPRU 1.2.42R. GENPRU 1.2.73(1) G gives guidance on how a firm should project its financial position throughout an economic or business cycle in order to estimate both its capital resources and capital requirements. This applies to all firms, although different firms may be exposed to different cycles. The SREP process includes review of this output and results in a range of actions that can include additional capital requirements as appropriate.⁸ Where specific risks are identified under Pillar 2 and are not specifically mitigated, we identify these as adjustments to the Pillar 1 minimum capital requirements.
- 3.3 We also clarified in CP08/24 that BIPRU 2.2 requires firms to hold sufficient capital now to meet their overall financial adequacy rule (GENPRU 1.2.26R) in the face of a stress scenario after allowing for realistic management actions.
- 3.4 To meet this rule, firms must submit a capital plan showing the effect of a range of stress tests relevant to the risks associated with their business. BIPRU firms should submit this in the ICAAP submission.

8 CRD Article 136(2)

Pillar 2 adjustments to the Pillar 1 minimum and capital planning buffers

- 3.5 In this CP we make a distinction between our view of adequate financial resources, which is explicitly linked to ICG, and capital planning buffers. The graph in Fig. 1 illustrates a highly simplified example of the difference between Pillar 2 outcomes that are related to ICG, which may be seen as an adjustment to minimum capital requirements (Pillar 2A), and Pillar 2 outcomes relating to the variable capital planning buffer (Pillar 2B).
- 3.6 Pillar 2A includes elements that are identified as a result of our review of a firm's risks where we may identify specific risk factors that require additional capital. It can be interpreted as additional capital held to supplement the regulatory minimum where risks (e.g. credit concentration risk) have either been identified but not captured, or not adequately captured in the first instance, in the Pillar 1 minimum.⁹ The CPB, or Pillar 2B, however, represents a buffer that is not part of the regulatory minimum. It is a sum identified now that can be drawn down in a stress situation. The objective of identifying this sum now is so that capital resources are available to absorb losses and meet increasing capital requirements when needed.
- 3.7 We may at times and under certain circumstances, set a capital planning buffer that we would want a firm to hold in the future which should be built up over time. For example, during times of adverse external stress, we may set a target level for capital planning buffers which we would require firms to build up over time. We would communicate this target to a firm separately from a capital planning buffer that should be held now. See Section 4 on 'Rebuilding capital planning buffers'.

Fig. 1: Illustrative example of Pillar 2 minimum regulatory capital and the CPB



⁹ CRD Article 136(2) "A specific own funds requirement in excess of the minimum level laid down in Article 75 shall be imposed by the competent authorities at least on the credit institutions which do not meet the requirements laid down in Articles 22, 109 and 123, or in respect of which a negative determination has been made on the issue described in Article 124, paragraph 3, if the sole application of other measures is unlikely to improve the arrangements, processes, mechanisms and strategies sufficiently within an appropriate timeframe."

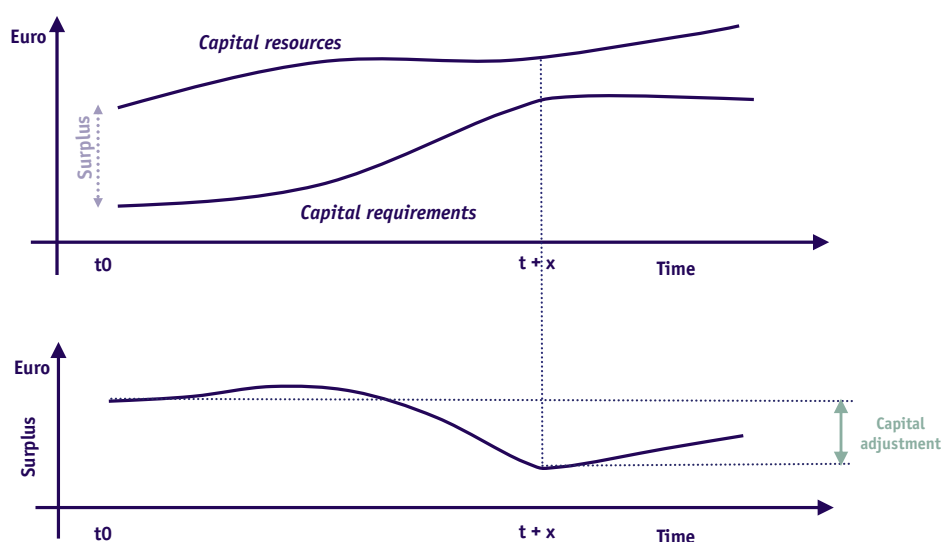
Identifying capital planning buffers

- 3.8 When we receive firms' ICAAP documents, we assess the stressed capital plan and the mitigating actions that are put forward by the firm. We may do analysis of our own to challenge the firm's submission. The net result of these quantitative and qualitative assessments is currently reflected in the ICG given to a firm as part of the SREP. ICG is typically expressed as follows:

Our view of adequate financial resources under GENPRU 1.2.26 (R) is ICG = X% of CRR (to capture e.g. concentration risk and interest rate risk in the non-trading book) + £Ym (capital planning)

- 3.9 Therefore, we already ask firms to hold a specific capital sum now which is available to absorb potential losses and meet potentially higher total regulatory capital requirements in a future stress scenario. We do not see the proposed CPB as a part of the total regulatory capital requirements that must be met at all times. However, it is clear that this has not always been well understood by firms, partly because we have articulated the CPB as part of total ICG, albeit by separately identifying the particular sum that should be held for capital planning purposes.
- 3.10 The graph below is a stylised illustration of how we identify the amount of capital planning buffer that is appropriate to be held now such that the firm can meet its regulatory capital requirements in the future, demonstrating that, were the severe stress to develop and economic conditions deteriorate, capital requirements would increase and capital resources would fall. So, we would expect that in such circumstances, capital planning buffers would be drawn down. See also Annex 2 for an example of the calculation of the capital planning buffer.

Fig. 2: Stylised illustration of how the capital planning buffer is identified



Capital planning and credible management actions

- 3.11 When considering the appropriate level of a firm's capital planning buffer, we assess granular, quantified stress impacts on capital requirements and capital resources, together with any mitigating actions with detailed timings of when such actions will be taken. This should produce a capital planning buffer as a result of a severe stress that is 'net' of realistic and credible management actions.
- 3.12 In our experience, the mitigating actions that firms put forward to offset gross impacts have included (often in some combination): slower projected balance sheet growth or faster shrinkage; growth or shrinkage in capital resources; raising new capital resources; and the ability to reduce capital distributions. Some of these actions may be put in place now. Others may be actions that we would be prepared to accept if the stress crystallised. Either way, the range of mitigating actions taken by the firm is a decision for senior management but as we have made clear in PS09/20, recent experience should be taken into account in considering the credibility of management actions. We will exercise caution in this respect and will require that management actions are demonstrably credible.

4 Setting and using capital planning buffers

- 4.1 The capital planning element of the ICG, as currently set, is explicitly designed to absorb losses in a severe stress. Firms are expected to assess the CPB against movements in capital resources and capital requirements by undertaking a stress test under Pillar 2 for capital planning purposes using an appropriately severe scenario.

Scenario selection

- 4.2 In PS09/20 we set out our expectations of the appropriate severity of stress that firms would use for the Pillar 2 capital planning buffer.
- 4.3 We said that firms should consider designing a range of their own scenarios that should include an ‘appropriately severe’ downturn scenario for capital planning purposes in line with our rearticulated guidance¹⁰ that is based on consideration of forward-looking hypothetical events calibrated against the most adverse movements in individual risk drivers experienced over a long historical period. Where appropriate, a firm might consider a market shock followed by an economic downturn.
- 4.4 We also explained that, going forward, we are likely to identify supervisory recommended scenarios that we generally expect firms to use as an informative adverse ‘anchor’ scenario to guide their calibration of their own scenarios.¹¹ We noted that we may also require certain firms to incorporate specific stress scenarios into their ICAAP submissions. In certain circumstances, we may undertake our own stress tests as part of the SREP, in addition to the firm’s own assessment.
- 4.5 In PS09/20 we also discussed our approach to the relationship between the economic cycle and stress scenarios as follows:
- 4.6 *‘The feedback received to CP08/24 indicated that firms would like additional clarity on how scenarios used for Pillar 2 capital planning purposes should change with the economic cycle.’*

10 As set out in PS09/20.

11 See section on Supervisory recommended scenarios in PS09/20.

- 4.7 *Our intention for the Pillar 2 stress test is that scenarios should, as a starting point, reflect the most severe but plausible worst-case scenarios through which we expect firms to maintain minimum specified capital levels. We do not intend the scenario to be procyclical and therefore we expect it to reflect the position of the cycle at the time it is set. However, on a practical basis we do expect scenarios to be updated to reflect new macroeconomic information such that firms are always stress testing against a plausible worst-case scenario and therefore, absolute countercyclicality in the scenario would be undesirable.*
- 4.8 *Thus, whilst the Pillar 2 scenario should not simply be a fixed percentage change from a particular point in time (e.g. GDP should always fall by X percentage points regardless of the point of the economic cycle we have reached) it will change with experience. Even at the trough of a cycle, we would not expect the stress scenario to be less severe than the current baseline forecast and effective stress testing requires that scenarios reflect a potential downside from an already difficult position. However, scenarios should not automatically become more severe during a downturn and less severe in an upturn.’*
- 4.9 Firms are encouraged to use this information in their ICAAP submissions to help them understand our expectations in setting capital planning buffers. At the time of setting capital planning buffers in a period of stress we may take into account, where applicable due to timing issues, a firm’s actual performance in the initial period of stress.

Rearticulating our approach to setting capital planning buffers

- 4.10 In previous years, we stated that when firms identified that they would need to draw down the CPB they should write to us and that we would consider, on a case-by-case basis, whether this was appropriate and we would reset ICG accordingly.¹² Recognising the challenges that firms were facing in identifying how and whether they could draw down the CPB, we further helped firms in 2009 by writing to trade associations.¹³ We explained that in adverse external circumstances, if a firm identified that its capital resources may fall below the level of its ICG for a short period, it should discuss this with us in advance – explaining why this may happen and outlining clear action plan to restore its capital position within a reasonable time-frame. We would consider the details of their case along with the capital plan for recovery and agree whether some temporary move away from ICG were appropriate.
- 4.11 Based on our experience and on feedback from firms, we now want to take the opportunity to simplify and provide further clarity about our expectations on the use of the CPB and the mechanism by which firms can use the buffer.
- 4.12 We intend to:
- re-articulate our expression of the CPB to help firms, their boards and their auditors understand that the CPB can be drawn down in adverse external

12 For further details see the following public statements: Pillar 2 update – expressing individual capital guidance to reflect stress tests (www.fsa.gov.uk/pubs/international/pil2_icg.pdf) and Our Pillar 2 assessment framework (www.fsa.gov.uk/pubs/other/Pillar2_framework.pdf)

13 See www.fsa.gov.uk/pubs/other/letter_to_bba.pdf

circumstances. We will identify ICG as our view, at a given point in time, of adequate financial resources that firms are required to meet at all times in accordance with GENPRU 1.2.26R. We will separately articulate an amount¹⁴ that we require firms to hold now as a capital planning buffer. By separately articulating this we intend that firms understand that the buffer is designed to be drawn down in a period of stress and that a drawdown of the CPB in line with the firm's capital planning would not necessarily result in the firm not meeting GENPRU 1.2.26R; and

- clarify that firms have clear responsibility for monitoring their potential draw down of the CPB, which they should interpret as a trigger point for supervisory discussion. If the severe stress, or something akin to it, started to develop and firms identify that adverse external circumstances are likely to cause, or have caused, their capital resources to fall such that their CPB would be eroded, they should write to us clearly explaining the circumstances for this. We expect these reasons to be related to adverse external circumstances such as macroeconomic downturns, financial/market shocks or other adverse external events. The firm should also include revised forward-looking capital plans, including how the CPB would be drawn down over time in line with capital projections under the severe stress. We will, as appropriate, acknowledge that we agree with its analysis, and that the CPB will be used in the manner it was intended. Where we are not satisfied with the explanation offered by a firm, for example because it arises from poor planning, we may insist on immediate action.¹⁵ We will not reset the CPB in response to such notifications. The level of the CPB will only be reviewed as part of an overall revision of a firm's ICAAP and re-setting of ICG. So, all things being equal, the CPB is designed to be available to absorb stressed losses and increased stressed capital requirements if a severe stress materialises and rebuilt as the economy recovers.¹⁶

Articulating ICG and CPB – an example of future wording

Our view of adequate financial resources under GENPRU 1.2.26 (R) is ICG = X% of CRR (to capture e.g. concentration risk and interest rate risk in the non-trading book).

We also consider that your firm should hold £Ym¹⁷ in excess of ICG capital resources as a capital planning buffer (CPB). The CPB has been set on the basis of the stress tests submitted by ABC bank/or (potentially) stress tests conducted by the FSA. The CPB is intended to ensure that ABC is able to withstand a stress scenario without breaching the overall financial adequacy rule. We acknowledge that your firm may need to use some of this buffer over the capital planning period should sufficiently adverse external circumstances transpire.

14 This may be articulated in a number of ways including a pound sterling sum, or a percentage of CRR or total ICG.

15 As outlined in Paul Sharma's letter to the British Bankers' Association (BBA) on 20 March 2009

16 We note that for some firms their stress situation will not be directly correlated with the economic cycle but the same principle – that the CPB is designed to be used up in adverse external circumstances and re-built when the external environment is favourable applies.

17 Although this example expresses the CPB as an absolute amount, we reserve the right to set this as a relative amount.

If your firm needs or expects that it will need to use the buffer, you should inform us in accordance with PRIN 11. Should you contact us in these terms, we would expect you to be able to demonstrate that the fall is due to adverse external circumstances. We will require a clear action plan setting out how the firm will strengthen its capital position within a realistic time period in order to restore the CPB. Where we are not satisfied with the explanation offered by you as to why you need to use your buffer, even on a temporary basis, we may insist on immediate action.

Q2: Do you agree that breaking the link between GENPRU 1.2.26 and the capital planning buffer will make it clearer to firms, their boards and their auditors that the CPB is designed to be drawn down during adverse external circumstances?

Monitoring the use of the capital planning buffer

- 4.13 Our response to a firm's notification that it needs to draw down its buffer will be determined by the event that caused it. For one-off, idiosyncratic events, we are likely to require rapid restoration. For erosion of buffers in adverse economic or other reasonable external circumstances, we are likely to allow firms more time to gradually restore their buffer. To do otherwise would be pro-cyclical. If we agree with the extent to which a firm's capital planning buffer will be eroded, we will respond, in writing, with our view of the firm's analysis and the use of the CPB according to its capital plan.
- 4.14 In our response to a firm's request to use the CPB, we are likely to identify additional reporting mechanisms that will help us monitor its use. For example, we might ask the firm to update us regularly and we might identify specific trigger points which would lead to enhanced supervisory intervention.

For example, we might specify the following:

- The firm should at least keep us informed at x monthly periods that the use of the CPB is proceeding according to its capital plan. This would potentially include updates on how the firm is carrying out the management actions it has committed to undertake in the stress scenario.
- Any material deviation away from the capital plan should be notified to us immediately.
- The firm should write to us as it consumes agreed percentages of the CPB. Such trigger points could provide a framework for dialogue between the firm and its supervisor about enhanced management actions where necessary.

Rebuilding capital planning buffers

- 4.15 If firms apply to use their capital planning buffer we expect them to outline a forward-looking capital plan identifying how they are likely to rebuild their CPB over time. When reviewing a firm's capital plan, we will take account of the economic context at that time.

- 4.16 Similarly, we may, at times and under certain circumstances, identify a capital planning buffer that we would want a firm to hold in the future which should be built up over time (for example, when setting capital planning buffers during times of adverse external circumstances). This would effectively become a future target that we would tell the firm about separately from any capital planning buffer that should be held now.

Growth scenarios

- 4.17 We explained in PS09/20 that as part of its ICAAP submission a firm must stress a range of scenarios including a severe downturn which, in our view, may serve as the basis for setting a CPB. We note that there may be occasions when effective capital planning requires the identification of growth scenarios. For example, a firm that has drawn down its CPB may submit a capital plan that includes a growth scenario to identify how it intends to restore capital levels and reach possible capital targets in economic conditions that are benign. We do not, at present, intend to make the inclusion of a growth scenario a requirement and firms do not have to submit a growth scenario as part of their ICAAP submission. However, we may ask some firms to do this under our current rules.

Capital planning buffers, risk appetite and firms' own buffers

- 4.18 One key reason we are proposing to break the link between GENPRU 1.2.26R and the CPB is to ensure that all relevant stakeholders understand that, while significant, drawing down a CPB is not the same as breaching a required regulatory minimum. We intend that firms, their boards and their auditors regard the use of the CPB as a trigger point for heightened supervisory interaction.
- 4.19 We understand that the stated risk appetites of many firms already identify a specific buffer to be held over and above minimum capital adequacy requirements. This buffer is the responsibility of the firm. However, we intend that, by breaking the link with GENPRU 1.2.26R, the regulatory capital planning buffer can be more easily understood in the context of firms' own buffers and therefore boards may incorporate the CPB into their own internal buffers where appropriate.
- 4.20 We wish to impress on boards and auditors that a firm's use of its CPB, as a result of adverse external circumstances, would not result in a breach of minimum capital adequacy requirements, provided that the firm is able to continue maintaining adequate financial resources taking into account all relevant circumstances.
- 4.21 We understand that some firms feel that we should not identify a capital planning buffer at all, but should leave buffer decisions entirely to firms' own business decisions and monitoring. While we expect, as above, that the CPB and firms' own buffers will often be identified in the same context, the reason we explicitly identify CPBs as a trigger mechanism is to provide comfort that it will be available to absorb losses or meet increasing capital requirements during a stress situation to ensure a firm remains above regulatory minimum requirements.

Q3: Do you have any comments on our approach regarding the use, monitoring and rebuilding of capital planning buffers?

5 Specifying ICG or CPB in particular forms of capital

- 5.1 At present, we may articulate ICG as a combination of capital resources of varying amount, type and quality that we consider appropriate for the firm to hold in order to comply with GENPRU 1.2.26R. Our related BIPRU guidance (BIPRU 2.2.17G) identifies various choices in setting ICG and, accordingly, we may set ICG on varying forms of capital as individual cases require.
- 5.2 To help firms understand the potential ways that we may express CPBs, or elements of ICG, we are clarifying that we may at times give guidance to firms, which specifies elements of the CPB or ICG that should be held in particular forms of capital. We would do this on a case-by-case basis to ensure that: (i) firms can meet all relevant capital ratios in the supervisory framework at all points in the economic cycle; and (ii) they have sufficient capital to absorb losses and meet increases in capital requirements in a downturn. For example, it may be necessary to specify qualities of capital, such as Core Tier 1, so that the CPB can effectively absorb some level of unexpected losses during adverse external circumstances and allow a firm to meet all relevant capital ratios in the supervisory framework at all points in the economic cycle.
- 5.3 This CP does not identify new capital ratios nor does it identify new definitions of capital. However, there are already a number of capital ratios within our supervisory framework that we expect particular firms to meet under stressed conditions¹. For example, we have identified that some firms should be able to meet 4% Core Tier 1 in a stress and we expect this to form one input into the capital planning process.
- 5.4 An example of the way in which we may express that elements of the capital planning buffer should be held in particular forms of capital could be as follows:

Our view of adequate financial resources under GENPRU 1.2.26 (R) is ICG = X% of CRR (to capture e.g. concentration risk and interest rate risk in the non-trading book).

We also consider that your firm should hold £Y m in excess of ICG capital resources as a capital planning buffer (CPB). We expect you to hold £Zm of the £Ym in Core Tier 1 capital.

The CPB, has been set on the basis of the stress tests submitted by ABC bank/or (potentially) stress tests conducted by the FSA. The CPB is intended to ensure that

ABC is able to withstand a stress scenario without breaching the overall financial adequacy rule. We acknowledge that your firm may need to use some of this buffer over the capital planning period should sufficiently adverse external circumstances transpire.

If your firm needs or expects that it will need to use the buffer, you should inform us in accordance with PRIN 11. Should you contact us in these terms, we would expect you to be able to demonstrate that the fall is due to adverse external circumstances. We will require a clear action plan setting out how the firm will strengthen its capital position within a realistic time period in order to restore the CPB. Where we are not satisfied with the explanation offered by you as to why you need to use your buffer, even on a temporary basis, we may insist on immediate action.

- 5.5 We are consulting on minor Handbook changes in BIPRU 2.2 to provide for the FSA specifying to firms that they should hold elements of ICG or CPB in particular forms of capital.

Q4: Do you understand our proposed clarification that we may specify elements of the CPB or ICG that should be held in particular forms of capital?

6 Other issues

Links with a future macro-prudential regime

- 6.1 The capital planning buffer is designed to ensure that a firm is able to meet its minimum regulatory capital requirements through an economic downturn taking account of the individual risks of a particular firm in the face of adverse external events. Firm-level analysis of its risks in adverse external circumstances is important for assessing the prudential soundness of the firm on a micro-prudential basis. This is different, although potentially related, to any system-wide counter-cyclical measures that may be introduced as part of a future macro-prudential regime. However, we are aware of the need to guard against any overlap in the outcomes associated with these two analyses. That is, we will work to ensure that there is consistency between the micro-prudential capital planning buffer and any future macro-prudential countercyclical measures.¹⁸

18 For further understanding of our current thinking regarding potential macro-prudential countercyclical measures, see DP09/4 *Turner Review Conference Discussion Paper – a regulatory response to the global banking crisis: systemically important banks and assessing the cumulative impact*.

Summary list of consultation questions

Section 2 – Market failure analysis, summary CBA and context for proposed changes

- Q1: Do you agree with our market failure analysis and our summary cost-benefit analysis?

Section 4 – Setting and using capital planning buffers

- Q2: Do you agree that breaking the link between GENPRU 1.2.26 and the capital planning buffer will make it clearer to firms, their boards and their auditors that the CPB is designed to be drawn down during adverse external circumstances?
- Q3: Do you have any comments on our approach regarding the use, monitoring and rebuilding of capital planning buffers?

Section 5 – Specifying ICG or CPB in particular forms of capital

- Q4: Do you understand our proposed clarification that we may specify elements of the CPB or ICG that should be held in particular forms of capital?

Example of the calculation of the capital planning buffer

The following example is to illustrate our view as to how capital planning buffers should be calculated. The purpose of the capital planning buffer is to ensure that firms maintain capital resources on an ongoing basis to allow them to absorb losses or increases in capital requirements that could occur in adverse external circumstances, such as an economic downturn, and meet minimum specified capital levels.

The example below displays the main outputs of a capital planning stress test analysis that forms the basis for the capital planning buffer calculation.

Fig. 3: A simplified example of the calculation of the capital planning buffer

ABC bank						
Stress testing outputs						
<i>(All data adjusted for realistic management actions)</i>						
	Dec-09	Dec-10	Dec-11	Dec-12	Dec-13	
ICG calculation	Capital requirements					
	<i>(Ebn's)</i>					
	RWAs	17.38	22.00	24.63	25.88	25.13
	Pillar 1 requirement	1.39	1.76	1.97	2.07	2.01
	Pillar 2 requirement	0.30				
	Initial ICG	1.69				
	as a % of Pillar 1	122%				
	Forecast ICG	1.69	2.14	2.40	2.52	2.44
Capital ratios	Capital resources					
	Core Tier 1 capital	1.24	1.52	1.23	1.32	1.43
	Initial total capital	2.69				
	Forecast total capital	2.69	2.50	2.47	2.72	3.01
	Tier 1 capital	1.92	1.80	1.51	1.66	1.86
	Core Tier 1 ratio	7.14%	6.90%	5.01%	5.09%	5.68%
	Total capital ratio	15.48%	11.36%	10.03%	10.51%	11.98%
Tier 1 ratio	11.05%	8.18%	6.14%	6.41%	7.40%	
CPB	Capital planning buffer					
	Movement in capital requirement (ICG) (A)	0.00	0.45	0.71	0.83	0.75
	Movement in capital resources (total capital) (B)	0.00	-0.19	-0.22	0.03	0.32
	Difference ((A) - (B))	0.00	0.64	0.93	0.80	0.43
	Maximum difference (capital planning buffer)	0.93				
						<i>To be used during stress</i>

In this example, we have made the following simplifying assumptions:

- The capital for Pillar 2 risks (Pillar 2A) is assumed to be set at the time of the supervisory review and does not change thereafter.
- The revised ICG only reflects the minimum Pillar 1 capital requirements that are adjusted for any additional capital relating to other material risks not accounted for in the Pillar 1 minimum. The forecast ICG is therefore an extrapolation of the revised ICG expressed as a fixed percentage of the minimum capital requirement. Therefore, for simplification, we have assumed there is no risk that was required to be singled out as a nominal amount.
- Also, in this example, ICG and the CPB have been set in relation to total capital only. However in practice, as described in Section 5, the FSA may specify elements of ICG or the CPB that should be held in particular forms of capital.
- All data are adjusted for realistic and credible management actions.

The capital planning buffer of £930m as set in this example, reflects the movement in capital resources and capital requirements over the stress period such that capital is available to absorb losses and meet increasing capital requirements in adverse external circumstances and is not used for other purposes.

It can be calculated as follows:

Step 1: Movements in capital requirements

For each year, calculate the difference between the forecast capital requirements and the initial capital requirement (i.e. forecast ICG minus initial ICG).

Step 2: Movements in capital resources

For each year, calculate the difference between the forecast capital resources and the initial capital resources (i.e. forecast total capital minus initial total capital).

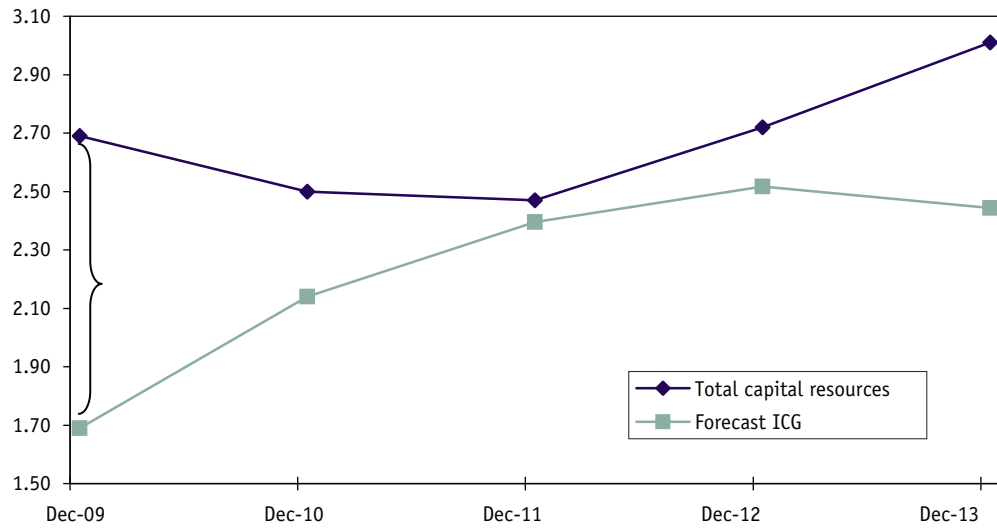
Step 3: Difference between resources and requirements

For each year, calculate the difference between the resources and requirements (i.e. the result from Step 1 minus the result from Step 2).

Step 4: Calculation of the capital planning buffer

The capital planning buffer is calculated as the largest amount from Step 3.

Fig. 4: Movements in capital resources and capital requirements over the stress period used to calculate the capital planning buffer



Compatibility with our objectives and the principles of good regulation

Introduction

1. This annex sets out our view on how our proposals for minor changes to the Handbook in order to simplify our approach to capital planning buffers are compatible with our statutory objectives and principles of good regulation.

Compatibility with our statutory objectives

2. The proposals set out in this CP, and the draft Handbook text that accompanies it, aim to meet our statutory objectives of market confidence and consumer protection.

Market confidence

3. This statutory objective requires us to maintain confidence in the UK financial system. Our draft Handbook rules and guidance seek to reduce the risk of market disruption arising from financial failure of an authorised firm or group of firms. We propose to minimise this risk by clarifying our intention that:
 - The CPB, set as part of our supervisory review under Pillar 2, can be drawn down in adverse external circumstances. To that end we intend to break the link between the CPB and our financial adequacy rule (GENPRU 1.2.26 R). This will assist firms, and their auditors, in understanding that the CPB is available to absorb losses and increased capital requirements in adverse external circumstances.
 - We may, at times, specify that elements of the CPB, or ICG, should be held in particular forms of capital. This will help to ensure that: (i) firms can meet all relevant capital ratios in the supervisory framework at all points in the economic cycle; and (ii) they have sufficient capital to absorb losses and meet changes in capital requirements in a downturn. For example, it may be necessary to specify qualities of capital so that the CPB can effectively absorb some level of unexpected losses during adverse external circumstances and allow a firm to meet all relevant capital ratios in the supervisory framework at all points in the economic cycle.

Consumer protection

4. Consumers may suffer detriment from the financial failure of a firm if: they suffer direct losses that are not fully guaranteed by the Financial Services Compensation Scheme; or if subsequently, there is a broader systemic failure that results in costs from government interventions or adverse economic impacts. Guidance that improves the standard of regulated firms' risk management and capital planning through clarity on the use of capital planning buffers, should reduce the risk to consumers from financial failure of a firm and therefore contribute to meeting the consumer protection objective.

Compatibility with the need to have regard to the principles of good regulation

5. Section 2(3) of the Financial Services and Markets Act 2000 (FSMA) requires that, in carrying out our general functions, we should have regard to the principles of good regulation. The most relevant principles in the context of this CP are set out below.

The need to use our resources in the most efficient and economic way

6. Our clarifications that CPBs can be drawn down in times of stress by breaking the link between CPBs and GENPRU 1.2.26R, should ensure that firms submit ICAAP/ICAS submissions that are better aligned to our expectations. This should lead to a reduction in resources required for us to undertake SREP reviews.

Responsibilities of those who manage the affairs of authorised persons

7. Understanding how capital planning works is critical for senior managers to make informed decisions about business strategy and risk management. The proposals outlined in this CP which clarify that capital planning buffers can be drawn down during external stress events without breaching regulatory capital requirements will help to mitigate the risk that its use will be misinterpreted by external stakeholders (such as investors and auditors).

Restrictions we impose on the industry must be proportionate to the benefits that are expected to result from those restrictions

8. The proposed Handbook changes outlined in this CP are designed to clarify our policy, but not introduce new requirements. We believe the changes outlined here do not give rise to incremental costs compared to the changes not being made, since these are clarifications of current requirements, which firms must comply with even if the proposed changes are not made. It is also our view that the benefits that greater clarity brings will apply to all relevant stakeholders.

Desirability of facilitating innovation in connection with regulated activities

9. Although the proposals outlined in this CP do not directly facilitate innovation in connection with regulated activities, they do not constrain the objectives of this principle.

The international character of financial services and markets and the desirability of maintaining the competitive position of the UK

10. Similar to the previous principle, although the proposals outlined in this CP do not directly affect the international character of financial services, they do not constrain the objectives of this principle.

Desirability of facilitating competition

11. The overall effect of proposals outlined in this CP should be to improve senior risk management decision-making through enhanced risk management. This should, in turn, lead to more effective competition.

List of acronyms

CBA	Cost-benefit analysis
CP	Consultation Paper
CPB	Capital planning buffer
CRD	Capital Requirements Directive
FSA	Financial Services Authority
FSMA	Financial Services & Markets Act (2000)
ICAS	Individual capital assessment
ICAAP	Internal capital adequacy assessment process
ICG	Individual capital guidance
MFA	Market-failure analysis
PS	Policy Statement
SREP	Supervisory review and evaluation process

Draft Handbook text

**PRUDENTIAL REQUIREMENTS
(CAPITAL PLANNING BUFFER) INSTRUMENT 2010**

Powers exercised

- A. The Financial Services Authority makes this instrument in the exercise of:
- (1) section 157(1) (Guidance) of the Financial Services and Markets Act 2000 (“the Act”):
 - (2) the other powers and related provisions listed in Schedule 4 (Powers exercised) to the General Provisions of the Handbook.
- B. The rule-making powers referred to above are specified for the purpose of section 153(2) (Rule-making instruments) of the Act.

Commencement

- C. This instrument comes into force on [].

Amendments to the Handbook

- D. The Glossary of definitions is amended in accordance with Annex A to this instrument.
- E. The Prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU) is amended in accordance with Annex B to this instrument.

Citation

- F. This instrument may be cited as the Prudential Requirements (Capital Planning Buffer) Instrument 2010.

By order of the Board
[Date]

Annex A

Amendments to the Glossary of definitions

In this Annex, underlining indicates new text and striking through indicates deleted text, unless otherwise stated.

Insert the following new definition in the appropriate alphabetical position. The text is not underlined.

capital planning buffer (in *BIPRU 2.2*) the amount and quality of capital resources that a *firm* should hold at a given time in accordance with the *general stress and scenario testing rule*, so that the *firm* is able to continue to meet the *overall financial adequacy rule* throughout the relevant capital planning period in the face of a stress scenario, after allowing for realistic management actions.

Amend the following as shown.

individual capital guidance (in *BIPRU 2.2*) *guidance* given to a *firm* about the amount and quality of capital resources that the *FSA* thinks the *firm* should hold ~~under~~ at a given time to meet the *overall financial adequacy rule* at all times as it applies on a solo level or a consolidated level.

Annex B

Amendments to the Prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU)

In this Annex, underlining indicates new text and striking through indicates deleted text.

The ICAAP and the SREP: the SREP

- 2.2.8 G The *FSA* will review ~~an a~~ a firm's ICAAP and, ~~if the firm has an IRB permission, including the result~~ results of the firm's stress test tests carried out under GENPRU and BIPRU 4.3.39R to BIPRU 4.3.40R (~~Stress tests used in assessment of capital adequacy for a firm with an IRB permission~~), as part of its *SREP*. Provided that the *FSA* is satisfied with the appropriateness of a firm's capital assessment, the *FSA* will take into account that firm's *ICAAP* and stress test tests in its *SREP*. More material on stress tests for a firm with an *IRB permission* can be found in *BIPRU 2.2.41R to BIPRU 2.2.45G*.
- ...
- 2.2.11 G As part of its *SREP*, the *FSA* will consider whether the amount and quality of capital which a firm should hold to meet its *CRR* in *GENPRU 2.1* (Calculation of capital resources requirements) is sufficient for that firm to comply with the *overall financial adequacy rule*. ~~Where the amount of capital which the FSA considers a firm should hold is not the same as that which results from a firm's ICAAP, the FSA expects to discuss any such difference with the firm. Where necessary, the FSA may consider the use of its powers under section 166 of the Act (reports by skilled persons) to assist in such circumstances.~~
- 2.2.12 G After completing a review as part of the *SREP*, the *FSA* will normally give that firm individual guidance (*individual capital guidance*), advising it of the amount and quality of capital which it should hold to meet the *overall financial adequacy rule*.
- 2.2.12A G As part of its *SREP*, the *FSA* will also consider the amount and quality of capital which the firm should hold as a *capital planning buffer* in accordance with the results of its stress tests and scenario analyses. The *FSA* will consider adequate a *capital planning buffer* which will allow the firm to continue to meet the *overall financial adequacy rule* throughout the capital planning period in the face of a stress scenario, after allowing for realistic management actions. The firm's *capital planning buffer* should be available only to absorb future losses or meet higher capital requirements if a severe stress scenario materialises.
- 2.2.12B G After completing a review as part of the *SREP*, the *FSA* may notify the firm of the amount and quality of capital which it should hold as a *capital planning buffer* over and above the level of capital recommended as its *ICG*.
- 2.2.12C G Where the amount or quality of capital which the *FSA* considers a firm should hold to meet the *overall financial adequacy rule* or as a *capital*

planning buffer is not the same as that which results from a *firm*'s *ICAAP*, the *FSA* usually expects to discuss any such difference with the *firm*. Where necessary, the *FSA* may consider the use of its powers under section 166 of the *Act* (Reports by skilled persons) to assist in such circumstances.

2.2.13 G If a *firm* considers that ~~ICG~~ the individual capital guidance given to it is inappropriate to its circumstances it should, consistent with *Principle 11* (~~relations~~ Relations with regulators), inform the *FSA* that it disagrees with that *guidance*. The *FSA* may reissue *individual capital guidance* if, after discussion with the *firm*, the *FSA* concludes that the amount or quality of capital that the *firm* should hold to meet the *overall financial adequacy rule* is different from the amount or quality initially suggested by the *FSA*.

2.2.13A G If a *firm* disagrees with the *FSA*'s assessment as to the amount or quality of *capital planning buffer* that it should hold, it should, consistent with *Principle 11* (Relations with regulators), notify the *FSA* of its disagreement. The *FSA* may reconsider its initial assessment if, after discussion with the *firm*, the *FSA* concludes that the amount or quality of *capital planning buffer* that the *firm* should hold as *capital planning buffer* is different from the amount or quality initially suggested.

...

2.2.15 G If, after discussion, the *FSA* and a *firm* still do not agree on an adequate level of capital, the *FSA* may consider using its powers under section 45 of the *Act* to vary on its own initiative a *firm's Part IV permission* so as to require it to hold capital in accordance with the *FSA's* view of the capital necessary to comply with the *overall financial adequacy rule* or as a *capital planning buffer*. *SUP 7* provides further information about the *FSA's* powers under section 45.

...

The drafting of individual capital guidance and capital planning buffer

...

2.2.19A G Where the *FSA* notifies a *firm* that it should hold a *capital planning buffer*, the notification will state what amount and quality of capital the *FSA* considers that is adequate for the *firm* to hold as such. *BIPRU 2.2.17G* to *BIPRU 2.2.19G* apply for the purpose of this paragraph as they apply to *individual capital guidance*. References in those provisions to *individual capital guidance* should be read as also applying to *capital planning buffer*.

...

Failure to meet individual capital guidance and monitoring and reporting on the capital planning buffer

...

2.2.23 G BIPRU 2.2.20G—BIPRU 2.2.22G also apply to individual capital guidance on a consolidated basis as referred to in BIPRU 2.2.19G. When a firm’s analysis demonstrates that its capital resources are likely to fall to the point where its capital planning buffer will be eroded, the firm consistent with Principle 11 (Relations with regulators) should notify the FSA of this as soon as practicable. The firm’s notification should at least state:

- (1) what circumstances are likely to force the firm to draw down its capital planning buffer;
- (2) how the capital planning buffer will be gradually used up in line with the firm’s capital planning projections; and
- (3) what plan is in place for the eventual restoration of the capital planning buffer.

2.2.23A G The FSA will review the firm’s notification and may provide its own analysis and recommendations on the items listed in BIPRU 2.2.23G(1) to (3). The FSA may ask the firm to continue reporting to it on the use of its capital planning buffer in accordance with the plan referred to in BIPRU 2.2.23G(3) and may identify specific trigger points leading to enhanced supervision. In addition to the regular reporting which may be agreed with the FSA, the firm should notify the FSA as soon as practicable if the use of its capital planning buffer has deviated materially from the plan notified to the FSA.

2.2.23B G A firm should inform the FSA where its capital planning buffer is likely to start being eroded even if it has not accepted the FSA’s assessment as to the amount or quality of its capital planning buffer.

2.2.23C G BIPRU 2.2.20G to BIPRU 2.2.23BG also apply to individual capital guidance and to capital planning buffer on a consolidated basis as referred to in BIPRU 2.2.19G.

...

2.2.29 G (1) A firm may take into account factors other than those identified in the overall Pillar 2 rule when it assesses the level of capital it wishes to hold. These factors might include external rating goals, market reputation and its strategic goals. However, a firm should be able to distinguish, for the purpose of its dialogue with the FSA, between capital it holds in order to comply with the overall financial adequacy rule and to meet the risks set out in the overall Pillar 2 rule, capital that it holds as a capital planning buffer and that capital held for other purposes.

...

...

2.2.39 G To reduce the impact of cyclical effects, a firm should aim to maintain an adequate capital buffer capital planning buffer during an upturn in business and economic cycles such that it has sufficient capital available to protect

itself in unfavourable market conditions.

...

- 2.2.72 G A *firm* should not expect the *FSA* to accept as adequate any particular model that it develops or automatically to reflect the results from the model in any *individual capital guidance* or capital planning buffer. However, the *FSA* will take into account the results of a sound and prudent model when giving *individual capital guidance* or when dealing with the firm in relation to its capital planning buffer (see *GENPRU* 1.2.19G (Outline of provisions related to *GENPRU* 2.1 (Adequacy of financial resources))).

PUB REF: 003582

The Financial Services Authority
25 The North Colonnade Canary Wharf London E14 5HS
Telephone: +44 (0)20 7066 1000 Fax: +44 (0)20 7066 1099
Website: <http://www.fsa.gov.uk>

Registered as a Limited Company in England and Wales No. 1920623. Registered Office as above.