Policy Statement

10/14

Financial Services Authority

Capital planning buffers

Feedback on CP09/30 and final rules

September 2010

FSA

Financial Services Authority

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Annex 1: List of non-confidential respondents to CP09/30

Annex 2: Capital planning buffers - Case studies and examples

Appendix 1: Handbook text

This Policy Statement reports on the main issues arising from Consultation Paper 09/30 (*Capital planning buffers*) and publishes final rules.
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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.

List of acronyms used in this Policy Statement

ARROW	Advanced risk responsive operating framework
BIPRU	The Prudential sourcebook for Banks, Building Societies and Investment Firms
CBA	Cost-benefit analysis
CP	Consultation Paper
CPB	Capital planning buffer
CRD	Capital Requirements Directive
DTR	Disclosure and Transparency Rules
FSA	Financial Services Authority
FSMA	Financial Services & Markets Act (2000)
GENPRU	General Prudential sourcebook
ICAAP	Internal capital adequacy assessment process
ICA	Internal capital assessment
ICG	Individual capital guidance
MFA	Market failure analysis
PS	Policy Statement
RRP	Recovery and resolution plans

1 Overview

Introduction

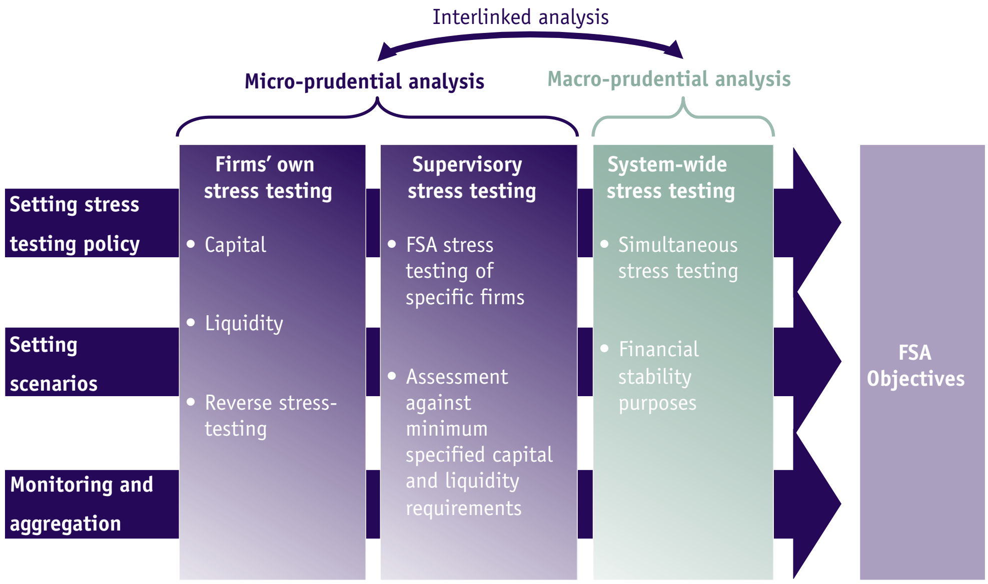
1.1 Regulatory stress testing of the adequacy of firms' capital and the consequent setting of capital buffers has been an integral part of prudential oversight in the UK since the Capital Requirements Directive (CRD) was introduced in 2007. At a time when significant attention is being paid to stress testing by national and international authorities, we will continue our approach of using firm-wide stress testing to assess firms' capital needs. Our approach – and the level of capital we consider adequate for firms to hold – has also been usefully informed by experience. In particular, the recent financial crisis highlighted the importance of firms being adequately capitalised to withstand a period of stress.

1.2 Our integrated approach to stress testing comprises three interlinked and mutually reinforcing elements:

i) firms' own stress testing;

ii) our stress testing of specific firms; and

iii) simultaneous system-wide stress testing undertaken by firms or supervisors using a common scenario for financial stability purposes.



1.3 This PS focuses on the first of these – firms' own stress testing (which may at times be informed by supervisory stress testing) – specifically on the firm-wide stress under Pillar 2. Firms are required to stress test individual risks on a standalone basis. In a firm-wide stress test, these individual components are then stressed collectively to assess how the firm would fare in severe adverse conditions.

1.4 It is through this firm-wide stress test that we set capital planning buffers (CPBs). A CPB is not part of the adequate financial resources, defined by Individual Capital Guidance (ICG), that firms must hold at all times (in accordance with GENPRU[1] 1.2.26R). It is an amount that firms hold now and is available to absorb losses and/or to cover increasing capital requirements in adverse circumstances, so the firm can meet the overall financial adequacy rule at all times.

1.5 No false comfort should be taken from capital levels that are set under regulatory stress tests. The Pillar 2 capital planning stress test focuses on one comprehensive and severe scenario, which acts as a proxy for a range of 'what if' hypothetical circumstances. However, it does not cover all possible scenarios and severities. The CPB identified on the basis of this stress test is one articulation of the amount of capital a firm should hold and use as a buffer. But firms should be making their own assessments, stress testing their specific models and circumstances, of the level of capital buffer they need to hold.

Background

1.6 The main purpose of the Handbook amendments set out in CP09/30 *Capital planning buffers* was to reassure firms, their boards and auditors that the CPB set under Pillar 2 can be used in adverse circumstances, rather than being an amount to be held at all times. We specifically proposed some minor Handbook changes to make the following points explicit:

- The CPB is designed to be available to absorb losses and/or to cover increased capital requirements in adverse circumstances that are outside the firm's normal and direct control. It does not form part of the adequate financial resources – the regulatory minimum – that firms must hold at all times (in accordance with GENPRU 1.2.26R).

1 GENPRU: The General Prudential sourcebook.

- The CPB is be set at a level that enables a firm to meet all relevant capital ratios specified in the supervisory framework at all points in the economic cycle. Therefore we may, at times, specify that elements of CPB, or elements of ICG, should be held in particular qualities of capital.

1.7 This PS summarises and comments on the responses received to the questions raised in CP09/30, describes our final policy and sets out the Handbook text that will clarify and give effect to that policy. However, aspects of the UK's regulatory approach to capital buffers may require review in the context of international developments. This includes implementing the Basel 3 package agreed by the Basel Committee, and governors and heads of supervision in September 2010.

1.8 Respondents to CP09/30 generally supported our intention to clarify that CPBs could be used in periods of stress. Therefore we are taking forward the high-level outcomes we proposed. However, as questions were also raised about how our approach operates in practice, in the PS we comment on some practical aspects of how we assess and apply CPBs.

1.9 The key points covered in subsequent sections of this PS include:

- **The history of our approach:** we describe how our approach to capital planning and setting CPBs has been an important element of our Pillar 2 framework for some years. The proposals in CP09/30 do not represent new requirements but simply clarify our established approach.
- **CPBs and pro-cyclicality:** we detail how our approach addresses the risk of pro-cyclicality in two ways: by the process used to set stress scenarios and by recognising that the CPB can be used in adverse conditions.
- **Circumstances under which the CPB can be used:** we explain that in addition to being available for use in circumstances such as macroeconomic downturns or financial/market shocks, the idiosyncratic nature of the CPB means there may also be firm-specific circumstances outside the firm's normal and direct control in which it becomes appropriate to use the CPB.
- **Disclosure obligations relating to the CPB:** we confirm that CPBs will be identified and set on a confidential basis. We also say that the level or use of the CPB in and of itself is not disclosable, but where applicable, firms need to be aware of potential obligations under the Disclosure and Transparency Rules (DTR).
- **Interaction with international regulatory developments:** our view is that a CPB set for an individual firm should not be additive to any capital buffers agreed internationally. We will continue to review our Pillar 2 framework in the context of international developments and will consult in due course on the UK's implementation of the European Directive giving effect to the final Basel 3 package. However, we conclude that analysis at the firm level will continue to remain important.
- **Using and monitoring the CPB:** in response to feedback received to CP09/30, we clarify that using the CPB should be a starting point for dialogue between a firm and its supervisor about the firm's capital position, not an automatic trigger

for additional supervisory intervention in the firm's business. We explain that any specific trigger points for future action would be determined on a case by case basis, taking account of the firm and the specific circumstances concerned. Supervisors may also put additional reporting arrangements in place to monitor using and rebuilding the CPB.

- **Future regulatory policy changes:** there will be several changes to the prudential regulatory framework over the coming years. These will be relevant to capital planning analysis and we set out the importance of considering, in capital planning stress tests, the impacts of future regulatory changes that are known and quantifiable. However, we recognise the importance of not 'front running' future policy changes and therefore, while firms will be expected to present a plausible glide-path to meet such changes as they take effect, we do not automatically require firms to capitalise in advance for the entire impact in their CPBs.

- **Quality of capital:** as explained in CP09/30, we may at times specify elements of ICG or CPB to be held in particular qualities of capital, to ensure firms can meet relevant supervisory ratios and that they hold sufficient loss-absorbing capital. We note the increased emphasis on firms holding higher quality capital and the specific monitoring of Core Tier 1 capital ratios for some firms. So it is likely that elements of CPB may be set in Core Tier 1 capital.

Who should read this paper?

1.10 The Handbook changes explained in this PS generally apply to BIPRU[2] firms including banks, building societies and CRD investment firms as relevant[3] (see page 16 for further details). Therefore, this paper will be of primary interest to banks, building societies and BIPRU investment firms. Board members, members of risk and capital committees (including non-executive directors), senior management, chief financial officers and chief risk officers, as individuals responsible for implementing and overseeing capital planning within a firm, should read this paper to understand our expectations.

1.11 The paper should also be of interest to external auditors to help them understand that the CPB is not a minimum regulatory requirement that firms must hold at all times in accordance with GENPRU 1.2.26R, but is available for use in adverse circumstances that are outside the firm's normal and direct control.

1.12 Insurers are unaffected by these clarifications as the Pillar 2 regime for insurers is different to that for BIPRU firms and the same market failures do not apply. We expect insurers to undertake capital planning and we explain in Annex 4 in PS09/20 *Stress and scenario testing* how we expect insurers to conduct relevant stress and scenario testing with associated capital planning to show how they would propose to maintain an adequate financial position.

2 BIPRU: The Prudential sourcebook for Banks, Building Societies and Investment Firms.

3 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.

Responses and our final policy approach

1.13 The consultation period for CP09/30 closed on 31 March 2010. We received 11 responses from a range of firms and trade associations. We are grateful to all respondents for taking time to send us their views. All non-confidential respondents are listed in Annex 1.

1.14 In Appendix 1 of this document, we set out our final Handbook text, incorporating changes to BIPRU to reflect our approach to CPBs and, in particular, making it clear that the CPB is available for use to absorb losses or meet increases in capital requirements in adverse circumstances that are outside the firm's normal and direct control. These clarifying Handbook changes are effective from 24 September 2010.

Structure of the Policy Statement

1.15 The rest of the PS is set out as follows:

- Section 2 provides an overview of the purpose of CPBs;
- Section 3 summarises feedback received to CP09/30 and our responses;
- Section 4 covers next steps and other points relating to capital planning buffers;
- Annex 1 lists all non-confidential respondents to the consultation;
- Annex 2 provides examples and case studies of calculating CPBs; and
- Appendix 1 contains the final Handbook text.

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 a potential impact on consumers. Firms are required to assess the adequacy of financial resources and make contingency plans against potential adverse circumstances.

2 The purpose of capital planning buffers

2.1 This chapter reviews the purpose of CPBs and how they are set as part of our existing Pillar 2 framework.

The purpose of capital planning buffers

2.2 Since the CRD was introduced in the UK in 2007, we have set firms' capital requirements under Pillar 1[4] and Pillar 2 (including an adjustment to supplement Pillar 1 capital as well as a capital planning add-on to be used in stressed conditions, i.e. the CPB).

2.3 In CP09/30, we further clarified the distinction between Pillar 2A and Pillar 2B. We defined Pillar 2A as the additional capital to be held to supplement the Pillar 1 capital requirement against risks such as concentration risk and interest rate risk in the non-trading book. Together with Pillar 1, it forms our view of adequate financial resources required under the overall financial adequacy rule (GENPRU 1.2.26R).

2.4 In contrast, Pillar 2B represents the CPB, which is not part of the regulatory capital requirement. The CPB is identified now so it can be used to absorb losses and/or to cover increasing capital requirements in adverse circumstances that are outside the firm's normal and direct control. Therefore the firm should be able to meet, at all times, the overall financial adequacy rule defined by its ICG, and any other capital requirements or supervisory ratios that are applicable[5] (e.g. the interim capital regime where relevant).

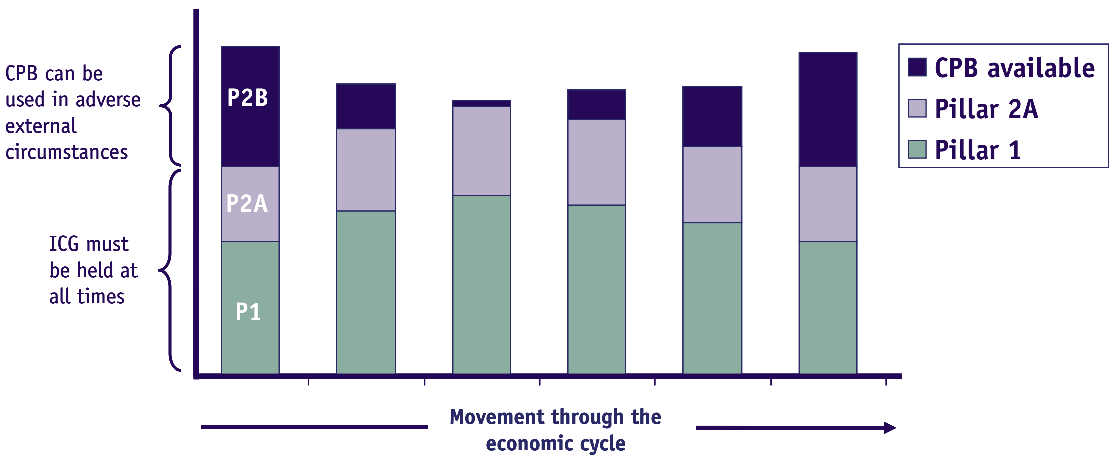
4 For banks, building societies and full-scope investment firms, the risks considered under Pillar 1 are credit, market and operational risk. Limited licence and limited activity investment firms consider the Fixed Overhead Requirement (FOR) as a proxy for winding-down costs under Pillar 1.

5 For simplicity for the remainder of this PS we refer to the CPB being set so that the firm can meet its ICG at all times, but firms should note other capital requirements and supervisory ratios that they may be required to meet.

2.5 Although CPBs have been set for firms for several years,[6] it became clear that firms were facing challenges from their boards and auditors about whether and how they could use the CPB. Accordingly, in CP09/30 we clarified our expectations regarding the use of the CPB and the basis on which a firm can draw upon it. Publicly increasing clarity about our approach to CPBs is consistent with our more general commitment to give greater clarity on all areas of Pillar 2 in order to improve firms' understanding of our supervisory expectations. We aim to do this in a manner which informs firms, but which does not prescribe or dilute firms' responsibility concerning how to appropriately manage their own risks.

2.6 In CP09/30, we stated that we will set ICG as our view, at a given point in time, of the adequate financial resources that a firm is required to maintain at all times in accordance with GENPRU 1.2.26R. Separately we will articulate an amount that the firm should hold currently as a CPB. By articulating the CPB separately from the ICG, we intend firms to understand that it is not part of the regulatory capital to be held at all times. Instead, the CPB is designed to be used in a period of stress and, therefore, using the CPB does not necessarily result in the firm not meeting GENPRU 1.2.26R. To make this clearer, we proposed some minor Handbook to BIPRU clarifications.

Figure 1 – Illustrative example of the CPB



Identifying capital planning buffers

2.7 CPBs are set through our existing Pillar 2 framework which involves dialogue between firms and their supervisors. They are set through a combination of analysis and calculation based on information the firm provides during its ICAAP[7] review which is supplemented, in some cases, by our own assessment. The analysis involves

6 For further details on the history of our approach, see Section 3.14.
7 ICAAP: Internal capital adequacy assessment process.

2.8 projecting the firm's capital resources and capital requirements over a three to five year horizon, incorporating the impacts of stressed conditions to assess movements in capital resources and capital requirements in adverse circumstances. On the basis of this stressed capital projection, we identify a fixed sum as a CPB that the firm should hold currently but is available for use should adverse circumstances materialise that are outside its normal and direct control.

2.9 If stressed conditions were to develop over the three to five year capital planning horizon (e.g. a deterioration in economic conditions, or the occurrence of more instantaneous financial/market shocks), we would generally expect capital requirements to increase (e.g. because of 'credit' risk rating migrations) and capital resources to fall (e.g. as a result of losses). Under such circumstances, we would expect the CPB to be used to absorb losses or to meet increasing capital requirements incurred under the stress without threatening the firm's ability to meet the overall financial adequacy rule, as identified through its ICG, at all times.

2.10 The CPB is identified by analysing movements in capital resources and capital requirements using the capital planning stress test, and consequently it should not be confused with a scalar linked to the quality of firm's governance or its risk management processes. For examples of how CPBs should be calculated see Annex 2.

CPBs and the economic cycle

CPBs are set on a forward-looking basis by assessing movements in capital resources and capital requirements in stressed conditions over a three to five year period. We have noted the potential interaction between identifying and using the CPB and movements in the economic cycle, and have sought to develop an approach to CPBs that addresses the potential risk of pro-cyclicality in two ways:

i) by how capital planning stress scenarios are set; and

ii) clarifying how CPB can be used in adverse conditions.

In PS09/20, we said that scenarios used in capital planning stress tests should be forward-looking and should change with experience, reflecting new macroeconomic information (as demonstrated, for example, in updating our supervisory recommended scenario). Therefore, while we still expect firms to hold a CPB that reflects a potential downside from an already difficult position, the CPB should not be set so it is automatically larger during a downturn and smaller in an upturn.

However, various elements of the CPB may clearly be impacted by cyclicality in different ways. In some cases, these can be addressed by our approach to setting scenarios for capital planning stress tests including, for example, our approach to updating our supervisory recommended scenario with new macroeconomic information. Other elements however, particularly those concerning idiosyncratic or market risk shocks, are less likely to be adjusted by applying these approaches and are more likely to be unaffected by the economic cycle.

In this PS we have also sought to clarify how the CPB is available for use in a period of stress on a forward-looking basis, and then re-built during more benign periods. This should help to address potential risks of pro-cyclicality.

The CPB is countercyclical insofar as it is designed to be used in times of stress, on the basis described in this paper. However, firms must be ready and able to meet their ICG at all times, recognising that conditions may deteriorate further, even if the firm is already experiencing a period of stress.

3 Consultation feedback and analysis of responses

3.1 This chapter outlines the responses received to the questions posed in CP09/30, our feedback and our policy decisions on how to proceed.

3.2 Respondents broadly welcomed our intention to clarify our approach to CPBs and, in the future, to define them as clearly separate from the ICG, which is our view of adequate financial resources to be maintained at all times. This was in line with industry requests for clarification in responses to CP08/24 *Stress and scenario testing*. Firms supported our intention to make it clear that CPBs are available to be used to absorb losses or increases in capital requirements in adverse circumstances, and should not be considered part of the minimum capital requirement to be held at all times.

3.3 However, respondents raised questions about how our approach would operate in practice, and requested clarification on several points such as public disclosure obligations relating to the CPB, and interaction with international developments. Concerns were raised about our approach to using and monitoring CPBs, particularly in relation to our statement in CP09/30 that using the CPB should be interpreted as a trigger for 'heightened supervisory interaction'.

3.4 Section 3 is set out as follows:

	Paragraph
Market failure analysis and cost-benefit analysis • Capital planning buffers – the history of our approach	3.5
Clarifying our approach to capital planning buffers • Consistency • Links with firms' governance and risk management • Interaction with firms' own buffers • Links with international developments • Public disclosure of CPBs	3.15
Using and monitoring capital planning buffers • Use of capital planning buffers • Monitoring use of capital planning buffers • Building and re-building capital planning buffers • Links with recovery and resolution plans	3.32
Specifying the ICG or CPB in particular qualities of capital • Contingent capital and capital planning buffers	3.48
Other issues raised by respondents to CP09/30 • Reissue of ICG letters • Transparency and clarity in identifying CPBs • Dynamic nature of the CPB • The level at which the CPB is set • Clarification between Pillar 1, Pillar 2A and Pillar 2B	3.57

Market failure analysis and cost-benefit analysis (CBA)

3.5 CP09/30 proposed minor changes to the current Handbook guidance to clarify our policy concerning CPBs but did not introduce new requirements.

3.6 In CP09/30 we said we concluded that our proposals did not give rise to incremental costs when compared to the changes not being made, as they clarified our existing Handbook guidance. We considered that the clarifications would reduce uncertainty about the capital planning element of our Pillar 2 regime, affecting all relevant stakeholders, including firms and their auditors.

3.7 We also set out that at times we may specify elements of the CPB or ICG that should be held in particular qualities of capital, e.g. Core Tier 1. This clarification makes our existing practice explicit. The proposal did not seek to introduce new qualities of capital or new capital ratios to which firms must adhere.

3.8 We asked:

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

3.9 We received a mixture of responses from firms and trade associations in respect of this question. While respondents welcomed our intention to clarify our approach to CPBs, they raised concerns regarding the implications of our clarifications.

3.10 In particular, some respondents suggested that CPBs were a new concept, representing a significant change to our existing framework and therefore would result in incremental costs to firms and additional resource requirements. Specific concerns were raised regarding smaller investment firms with non-complex business models and limited resources, which may not pose a significant systemic risk to the market. Therefore, it was suggested that our approach should be applied proportionately based on the risks of the firm rather than its size. Respondents also asked for clarity in relation to the scope of CPBs as they apply to small investment firms.

3.11 Respondents were concerned that CPBs constituted new 'hard' minimum capital requirements over and above the ICG, with others asking for confirmation that they are 'soft' recommended targets.

3.12 It was also suggested that our clarifications in CP09/30 were intended to achieve a 'zero failure' regime, with some feeling we expected perfect foresight of the risks that a firm could face.

3.13 Firms were concerned about additional costs for them should our proposals result in the application of 'buffers on buffers' and possible double-counting, given international developments in this area. One respondent queried whether the CPB could act as a barrier to entry to the industry. Firms also asked for clarification regarding how the capital planning buffer fits with firms' own internal buffers.

3.14 Some respondents were concerned about the cost of raising capital to build the capital planning buffer, particularly under adverse market conditions.

Our response: While we acknowledge the concerns expressed by respondents in the context of international regulatory developments and challenging economic conditions, we reiterate that setting CPBs is not new and therefore our approach does not result in incremental costs to firms.

We do not conclude that clarifying our approach in CP09/30 would result in firms having to make substantial changes to their systems or processes to monitor using the CPB or in preparing forward-looking capital plans. This is because, under our existing approach, firms should already undertake this type of regular monitoring and analysis of their capital position even without the clarifications in CP09/30. However, we note there may be some impacts on firms as a consequence of changes in regulatory reporting resulting from the CPB being separated from our view of adequate financial resources (ICG) and we have consulted on these changes separately (see Section 4.3 for more detail).

In CP09/30, we explained our intention to apply proportionality in implementing our approach as is currently the case in our Pillar 2 framework, stating that, in particular, some very small firms may not be set CPBs. Following respondents' requests for further clarity on this statement, firms should note that when assessing whether we set a CPB for a given firm, we will consider the nature, scale and complexity of a firm's business and the major sources of relevant risks to such business. For example, where a limited licence investment firm is subject to holding winding-down costs (or Pillar 2 if this is higher) as its capital requirement, we would not normally expect to set a CPB. However regardless of whether we set a CPB, we still expect all BIPRU firms to undertake capital planning analysis looking three to five years ahead in accordance with our existing requirements.

We were clear in CP09/30 that we did not consider CPBs to be part of the regulatory minimum for adequate financial resources that firms are required, under GENPRU 1.2.26R, to maintain at all times. A CPB is an amount we expect a firm to use in adverse circumstances that are outside its normal and direct control to absorb losses and/or cover increases in its capital requirements. It is therefore not a new regulatory minimum over and above the ICG that a firm should hold at all times. Rather, it is an amount that a firm should hold currently, but that can be used in defined circumstances, so the firm can meet the overall financial adequacy requirement (as set out in the firm's ICG) at all times. This does not mean that in setting CPBs as part of our Pillar 2 framework we are attempting to create a 'zero failure regime', and we note that firms should undertake their own assessment of the level of capital buffer that is sufficient for their own purposes.

Furthermore, the explicit purpose of the clarifications proposed in CP09/30 was to make it easier for firms, their boards and auditors to understand that the CPB is separate from any regulatory capital requirement, and is designed to be used in adverse circumstances outside the firm's normal and direct control. Clarity about our approach to setting CPBs and their use should dispel any misperception that they create a barrier to entry to the industry. We discuss our approach about using and monitoring CPBs in Section 3.32, which aims to address respondents' concerns that the buffer might be considered part of their minimum regulatory requirements.

We provide further detail below about the history of our approach to CPBs, and address respondents' concerns that the clarification represents a significant change in our approach.

We understand the industry's concerns about continuing international discussions on capital buffers and we conclude that any CPB set for an individual firm should not be additive to any capital buffers agreed internationally. We provide more detail on how our approach to CPBs fits with international developments in Section 3.27.

In Section 3.25, we set out our position on how firms' internal buffers should interact with CPBs, in response to comments received from industry.

In response to some firms' concerns about raising capital under challenging economic conditions to meet the CPB, we discuss how our approach addresses the potential risk of pro-cyclicality in more detail in Section 2.9 and set out our approach to setting forward-looking target CPBs in some exceptional cases in Section 3.45.

Capital planning buffers – the history of our approach

We have set CPBs for firms since the CRD was implemented in the UK in 2007. In particular, CPBs were set as part of the ICG in accordance with the rules stated under GENPRU 1.2.26R (overall financial adequacy rule), GENPRU 1.2.30 R (overall Pillar 2 rule) and GENPRU 1.2.42 R (general stress and scenario testing rule).

To satisfy themselves that they could meet the financial adequacy rule at all times, firms needed to understand the impact on their financial resources of adverse circumstances. In accordance with GENPRU 1.2.30R, a firm is required to have processes, strategies and systems in place to assess and maintain, on an ongoing basis, the amounts, types and distribution of financial resources, capital resources and internal capital that it considers adequate to cover:

(a) the nature and level of the risks to which it is or might be exposed;

(b) the risk in the overall financial adequacy rule; and

(c) the risk that the firm may not be able to meet its capital resource requirement in the future.

Previously, analysis undertaken by firms to assess their capacity to meet the overall financial adequacy rule on a continuing basis through the cycle resulted in setting add-ons for capital planning as appropriate. These were included in the articulation of the ICG. They were, in effect, CPBs.

We publicly communicated this approach in several key statements, which explicitly stated the existing requirement on firms to meet their ICG in stressed conditions:

- **Pillar 2 update**[8] – in discussing how best to express ICG, we stated that where firms may be required to hold more capital now, we wanted this element to be a separately identifiable part of the ICG that we set.
- **CRD implementation bulletin**[9] – here we outlined our formulation expressing ICG as: ICG = a% x CRR + £b where 'a' was an adjustment expressed as a percentage of the Pillar 1 minimum capital requirement (also known as the Capital Resources Requirement or CRR) and 'b' was an absolute capital amount reflecting the outcome of the economic cycle stress test that firms must carry out under Pillar 2.
- **Our Pillar 2 assessment framework**[10] – we publicly communicated that under element 4 of the SREP process, we assess how future changes in a firm's balance sheet can affect its future capital requirements. We also set out that, as part of the SREP process, we would consider whether a firm should hold a capital buffer to ensure it can meet its regulatory capital requirements during stressed conditions.

8 See www.fsa.gov.uk/pubs/international/pil2_icg.pdf published in September 2006.
9 See www.fsa.gov.uk/pubs/international/CRD_bulletin5_bank.pdf published in November 2006.
10 See www.fsa.gov.uk/pubs/other/Pillar2_framework.pdf published in May 2007.

This is the approach under which we have been setting capital planning add-ons for firms in our existing Pillar 2 framework. Firms will have seen this approach applied in our expression of the ICG, which usually includes a separate amount that reflects a capital planning add-on identified by the firm's capital planning stress test:

The individual capital guidance for [insert firm name(s)] is to hold total capital resources of at least [a%] of the capital resources requirement plus £c for e.g. pension risk and *£b for capital planning*.

Therefore, while we acknowledge that the specific term 'capital planning buffer' may not have existed before CP09/30 was published, the concept has been given practical effect through our Pillar 2 framework for several years and does not constitute a new requirement.

Clarifying our approach to capital planning buffers

3.15 In CP09/30, we proposed clarifying our expression of the CPB, in order to help firms, their boards and their auditors understand that the CPB can be used in adverse external circumstances. In CP09/30 we said that the ICG is our view, at a given point in time, of the adequate level of capital that firms should hold at all times in accordance with GENPRU 1.2.26R. We would then say separately how much capital resources that we would expect firms to hold currently as a capital planning buffer. Using the CPB as a result of 'adverse external circumstances' would not necessarily result in the firm breaching the requirements under GENPRU 1.2.26R.

3.16 We explained in CP09/30 that a firm will be able to use its capital planning buffer in adverse external circumstances (e.g. macroeconomic downturns, financial/market shocks or other adverse external events). However, we explained that a firm should not draw down its capital planning buffer for reasons that are clearly unrelated to adverse external circumstances (e.g. an acquisition).

3.17 We also stated that firms are clearly responsible for monitoring their potential usage of the CPB, which they should interpret as a trigger for supervisory discussion. We set out steps the firm should follow if a severe stress begins to develop, and a firm consequently identifies it would need to use its CPB:

- the firm should write to us clearly explaining the circumstances for using the CPB; and
- the firm should include revised forward-looking capital plans, showing how the CPB would be drawn down over time in line with the severe stress and subsequently rebuilt.

3.18 We explained that, in general, the CPB would not be reset in response to notifications regarding its use, but would be reviewed as part of revising a firm's ICAAP and re-setting its ICG. This may be part of the firm's SREP process or when changes in the business, strategy, nature or scale of its activities or operational environment suggest that the current level of adequate financial resources needs to be revised.

3.19 We asked:

> 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?

3.20 Respondents broadly supported breaking the link between GENPRU 1.2.26R and the CPB. However, they noted that users of firms' risk management information would need to be re-educated. Respondents raised questions about how this approach would work in practice and its interaction with other regulatory initiatives; see below for more detail.

Our response: We welcome respondents' support for our intention to break the link between CPBs and the overall financial adequacy rule, i.e. to make it clearer that the CPB is available to be used in adverse circumstances outside the firm's normal and direct control. However, we recognise that respondents would like more clarity about how our approach will operate in practice and have also asked for clarification of our current thinking in several areas. We address the specific comments we received below.

Consistency

3.21 Some respondents queried how to implement a consistent approach across firms for CPBs given that changes in the economic cycle affect different firms in different ways, both in terms of their timing and impact. Concerns were expressed about potential 'gaming' of the approach to try to reduce the size of the CPB, given the sensitivity of the CPB to the scenarios chosen and to management actions. Respondents requested that we ensure that stress scenarios used are consistent in terms of severity, but remain relevant to individual firms, so firms retain the flexibility to develop their own scenarios. There was broad support for our supervisory recommended scenario published in March 2010, and for additional guidance on management actions.

3.22 Additional measures to foster consistency in calculating the CPB were suggested, including standardised loss tables, guidance on the granularity of calculation of results, and documentation.

3.23 Respondents also raised concerns that enhanced stress testing may result in higher capital requirements for firms, and suggested that we should emphasise identifying weaknesses/vulnerabilities in business models through stress testing and scenario analysis, rather than quantifying a capital planning buffer.

Our response: In PS09/20 *Stress and scenario testing*, we took a number of steps to strengthen our stress testing regime. We also tried to clarify our expectations of firms to improve consistency across the regime and in firms' understanding of our requirements. However it is important to note that these measures, and our peer review and challenge of firms' stress testing results under the SREP process, are designed to achieve a consistent approach between firms and will not necessarily result in identical outcomes. The measures in PS09/20 included:

Introducing supervisory recommended scenarios[11]

For most firms, the supervisory recommended scenario serves as an 'anchor' scenario they can use as a starting point to help them determine the severity of their own scenarios for capital planning stress tests. The recommended scenario articulates our risk tolerance of the minimum adverse conditions through which we expect firms to be able to meet minimum specified levels of capital (this could include the interim capital regime where relevant, the ICG or other relevant capital requirements): it therefore provides a consistent basis to help firms calibrate the severity of their own scenarios. Aside from the recommended scenario, some firms will also occasionally be asked to run specific scenarios to be included in their ICAAP submissions. Nonetheless, all firms remain responsible for developing their own scenarios that are appropriately severe and focus on the risks relevant to them.

Firms should also note that, as stated in PS09/20, their capital planning stress testing scenarios should be updated regularly to reflect new macroeconomic information, so they always stress test against a severe but plausible scenario.

Our approach to assessing management actions

In PS09/20, we set out our approach to assessing the management actions proposed and quantified by firms, and explained that we generally exercise a degree of caution when assessing their likely effectiveness. We outlined our expectation that firms should consider management actions in the context of the system as a whole rather than in isolation, and should consider their feasibility and credibility in a stress situation. In that context, we also set out our conservative approach in relation to guarantees or commitments of parental support as acceptable management actions. In PS09/20, we stated that only in exceptional circumstances could we accept parental support as a mitigating management action. Even in those cases, we said that the onus would be on the firm to demonstrate that the arrangement is legally enforceable, effective, credible and would be forthcoming in stressed conditions (i.e. the parent will not be under such stress that it is unwilling or unable to effect the transfer of capital to its subsidiary).

We conclude that these steps have served to promote consistency in setting CPBs that are 'net' of realistic and credible management actions, and help to mitigate the potential risk of 'gaming' the approach by setting scenarios and management actions the firms have proposed. In this context, we will continue to explore ways to improve this consistency while ensuring firms retain flexibility to tailor stress scenarios and management actions, as they must, to the specific characteristics of their businesses.

11 The FSA published the high level parameters of its supervisory recommended scenario in the Financial Risk Outlook (FRO) 2010 and also on the FSA's stress testing webpages: www.fsa.gov.uk/Pages/About/What/International/stress_testing/firm_s/pillar_2_stress_testing/supervisory_recommended_scenarios/index.shtml.

We acknowledge that firms are affected differently by adverse conditions such as macroeconomic downturns, in terms of their impact and timing. For example, firms with significant dynamic trading books may experience their largest losses from the stress over a shorter time horizon than firms which operate primarily through non-trading books with relatively static exposures, and their analysis would reflect this. However, we view that our framework for setting CPBs using a consistent three to five year planning horizon, together with provision of the 'anchor' scenario, provides sufficient flexibility so all types of firms can identify relevant scenarios that reflect new macroeconomic information, while providing a consistent timeframe and expectation of appropriate severity.

We conclude stress testing should be an integral element of a firm's suite of risk management tools, and should therefore clearly assess a firm's risks under stressed conditions. Consequently we are committed to ensuring firms which undertake high quality, robust stress testing are not disadvantaged compared to those who do not conduct stress testing of sufficient quality to meet our expectations. We detail our expectations about good practice in stress testing in Annex 3 of PS09/20, and we intend to build these into our supervisory process.

Links with firms' governance and risk management

3.24 Several respondents requested that setting CPBs should take into account a qualitative assessment of a firm's governance and risk management models, its culture and the strength of its business, perceiving CPBs as a mechanism to address poor risk management practice within a firm. These respondents requested that CPBs should not be set so they penalise firms with strong corporate governance and risk management infrastructures.

Our response: The CPB's aim is to provide a buffer of capital that firms can use to absorb losses or cover increased capital requirements in adverse circumstances, so they can meet the overall financial adequacy rule at all times. It is calculated by projecting a firm's capital resources and requirements under stressed conditions over a three to five year horizon as set out in GENPRU 1.2.42 R and related guidance, in particular GENPRU 1.2.73AG. Therefore, the CPB amount does not directly relate to the quality of a firm's governance and risk management practices and should not be considered as any sort of capital scalar that will vary directly with a qualitative assessment of a firm's governance and risk management capabilities. Such qualitative assessments would inform the setting of the firm's ICG rather than the CPB.

However, we realise that CPBs should reflect the strength of a firm's capital position and business model under stressed conditions. This is demonstrated in the approach used to calculate the CPB. CPBs are also set net of credible management actions that firms specify they will take to mitigate the impact of adverse conditions: these will indirectly reflect the quality of a firm's governance arrangements and its ability to respond to and manage the crystallisation of risks to which it is exposed.

Interaction with firms' own buffers

3.25 Respondents requested confirmation that our approach to setting CPBs would not penalise firms that currently undertake capital planning analysis and set their own buffers over the ICG. They requested clarification that if a firm already has an internal buffer in place above the ICG, it will count towards the CPB.

3.26 Respondents also questioned the need to formalise an approach to setting CPBs as many firms already set internal capital buffers to ensure they meet regulatory requirements at all times, where we are aware of this. Some expressed concern that firms would be required to establish their own separate internal buffer above the CPB.

Our response: In CP09/30, we recognised that several firms currently specify internal buffers to be held over and above minimum capital requirements such as the ICG, for risk management purposes and to satisfy external stakeholders. We explained that by clarifying that the CPB is to be used in adverse circumstances, rather than being considered as part of a regulatory minimum capital requirement, firms can incorporate the CPB into their own internal buffers as appropriate.

We view that any internal buffers firms may still choose to set are the individual firm's responsibility, in terms of their existence and their monitoring. Therefore, while we understand respondents' questioning of the need to specify CPBs in cases where internal buffers are set, identifying and setting CPBs remains an important part of the Pillar 2 framework. This gives comfort, in the context of the industry as a whole, that individual firms can meet the overall financial adequacy rule at all times. It also serves as a starting point for dialogue between a firm and its supervisor about the firm's individual capital position.

We reiterate however, that we do not aim to disadvantage firms that currently set internal buffers over and above their ICG. The clarifications in CP09/30 were intended to help firms more easily understand that the CPB can be used in adverse circumstances that are outside their normal and direct control, without it being considered as breaching minimum regulatory requirements.

Links with international developments

3.27 A number of respondents asked for further detail about how our approach to setting CPBs under Pillar 2 fits with international developments in this area. They emphasised the need for a level playing field internationally with regard to capital standards and warned against the risk of super-equivalence in the UK.

3.28 Respondents were concerned about overlap and double counting of capital buffers and requested that we engage with the industry on how the various approaches will operate together in practice. Respondents also questioned whether our approach to CPBs would undergo significant changes after a short period of time in view of continuing discussions regarding capital standards and warned against front running of emerging international developments.

Our response: There has been support in the UK[12] and internationally[13] for the idea of capital buffers that are built up in benign periods so they can be drawn down in stressed conditions, offsetting pro-cyclicality in the financial system. International discussions continue about developing these buffers.

In CP09/30, we acknowledged the potential interaction between CPBs currently set as part of our Pillar 2 framework and any system-wide counter-cyclical measures we may introduce as part of a future macro-prudential regime. We note the CPB has specific characteristics which differ from other capital buffers being proposed, as it is:

- a buffer determined using firm-specific analysis;
- designed to ensure that a firm can meet its minimum regulatory requirements at all times; and
- generally updated periodically as part of the SREP process.

We understand respondents' concerns about potential overlap between the CPB and other regulatory buffers in practice. Our view is that any CPB set for an individual firm should not be additive to any capital buffers agreed internationally. We will continue to review our Pillar 2 framework in the context of international developments and will consult in due course on the UK's implementation of the European Directive giving effect to the final Basel 3 package.

More generally we conclude that stress testing is an important tool to help firms identify idiosyncratic risks and assess their impact in stress conditions, alongside ensuring they have sufficient capital to minimise the risk of breaching capital adequacy rules. Therefore, we conclude that stress testing analysis at firm level will remain fundamental under a broader macro-prudential framework.

Incorporating future regulatory changes into CPBs

More generally, we note there are several regulatory policy changes being discussed both nationally and internationally. The future impact of such changes, while not directly assessed under Pillar 1 or Pillar 2A, could be a relevant input into firms' capital planning stress tests over the three to five year horizon as it is important that firms have sufficient capital in place to absorb the impact of regulatory policy changes as they occur, without risking their ability to meet their ICG.

However, we recognise the importance that forward-looking analysis to identify CPBs does not 'front run' future policy changes by immediately requiring capitalising the entire impact of a future policy change in the CPB. This is particularly important where there are transitional timetables in place to accompany the relevant policy changes. We also understand there may be some uncertainty about the quantifiable impact of regulatory policy changes, even when the changes themselves are known.

Therefore, while we expect firms to consider and analyse the impact of future policy changes where they are known and quantifiable as part of their forward-looking capital planning analysis (in some cases there may be some consideration of the impact of future known policy changes in setting the CPB), in general we would not automatically require firms to

12 Through The Turner Review and accompanying Discussion Paper DP09/2 (www.fsa.gov.uk/pubs/discussion/dp09_02.pdf).

13 See the Basel Committee Consultative Documents 'Strengthening the Resilience of the Banking Sector'. (www.bis.org/publ/bcbs164.pdf) and 'Countercyclical Capital Buffer Proposal '(www.bis.org/publ/bcbs172.htm). See also the February 2010 Public Consultation of the European Commission regarding further possible changes to the Capital Requirements Directive (http://ec.europa.eu/internal_market/consultations/docs/2010/crd4/consultation_paper_en.pdf).

capitalise for their entire impact within its CPB. It is more likely that firms will be asked to identify a glide-path, outside the CPB, to meet the impacts of regulatory changes as they take effect.

Public disclosure of CPBs

3.29 Many respondents requested that setting and using CPBs, along with any associated reporting, remains confidential between the firm and its supervisor, as is the case in the existing Pillar 2 framework. This view was expressed in relation to public disclosure of individual firm data as well as aggregated data. Firms also requested that we share any legal advice obtained that states that public disclosure of the CPB or its use will not be required. However respondents warned that even if public disclosure is not required, evidence of using the CPB would be apparent from changes in the firm's capital ratios.

3.30 Respondents also requested our reassurance about concerns that reputational damage may result from adverse market reaction to a firm's use of the CPB or, equally, create perverse incentives if firms try to obtain a competitive advantage against other market participants. They highlighted the danger that the market will interpret a decision by a specific firm to begin using their CPB as being a sign of weakness.

3.31 However, one respondent suggested that enhanced disclosure arrangements, requiring firms to disclose information about the CPB could allow the market to make more informed assessments about capital adequacy.

Public disclosure of CPBs

We set a firm's CPB, like its ICG, on a confidential basis. It is individual guidance given to a firm in accordance with the Supervision manual (SUP 9) and we will consequently not publish this guidance for general information as it refers to a firm's individual circumstances. Likewise, we conclude that firms should not publicly disclose the amount of the CPB we have set, or any information on their use of the CPB, as part of any Pillar 3 disclosure or in the form of any other market information.

Given the way that Pillar 2 operates under our current framework, we conclude that the level or use of the CPB is not in itself disclosable. However, where a firm is an 'issuer',[14] we remind them of their ongoing obligation under the Disclosure and Transparency Rules (DTR) to disclose inside information. In particular, there may be other external events or circumstances that arise which would trigger disclosure obligations, and it remains the firm responsibility to assess its obligations under these circumstances.

14 The term 'issuer' is defined in the Glossary of the FSA's Handbook in relation to Chapters 1,2 and 3 of the Disclosure and Transparency Rules (DTR).

Using and monitoring capital planning buffers

3.32 In CP09/30, we explained that how we respond to a firm's notification that it needs to use its CPB will be determined by the nature of the triggering event: for one-off idiosyncratic events, we may require rapid restoration but for events such as a macroeconomic downturn, we may allow firms more time to restore their CPB.

3.33 In response to a firm's request to use its CPB, we said we are likely to identify additional reporting mechanisms to help us monitor their use and may identify specific trigger points for firms such as:

- keeping us informed at *x* monthly intervals that use of the CPB is proceeding according to the firm's capital plan including implementing proposed management actions;
- notifying us immediately of any material deviation from the capital plan; or
- writing to us as the firm consumes predetermined percentages of the CPB.

3.34 We proposed that firms should provide us with a forward-looking capital plan identifying how they are likely to rebuild their CPB over time, taking account of the expected prevailing economic conditions.

3.35 We also stated that under certain circumstances, such as setting a CPB during stressed conditions, we might identify a CPB we would want a firm to hold in the future and which should be built up over time. This would effectively become a future target buffer, notified to the firm separately from any CPB that should be held now. We noted that there may be occasions when effective capital planning requires identifying growth scenarios to assess how a firm intends to restore capital levels. We are able under our current rules to ask a firm to model such scenarios.

3.36 We asked:

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

3.37 A number of respondents requested more detail about the intent of our approach regarding using, monitoring and rebuilding CPBs, and in particular, the references in CP09/30 stating that firms should regard it as a trigger point for 'heightened supervisory interaction'. Respondents asked for assurances that their use of the CPB will be understood by their supervisors and will not be considered as a breach of minimum capital requirements.

Using capital planning buffers

3.38 A common theme in responses was a request for further clarity about the circumstances under which the CPB can be used. One respondent also asked for clarification regarding the notification process in the case of a one-off idiosyncratic event that requires instant reaction on the firm's part, where contact and prior notification to the firm's supervisor about using the CPB is not feasible.

3.39 Respondents also asked for clarity regarding the consequences of using the CPB and how this would operate in practice. Confirmation was requested that legitimately using the CPB would not result in any adverse consequences for a firm. In particular, respondents emphasised that the autonomy and control of a firm's senior management should not be impeded as a result of using the CPB. They expressed concern that merely using the CPB would trigger increased supervisory intervention in their businesses, which would imply that the CPB is a regulatory minimum.

3.40 As stated previously, respondents raised concerns about potential public disclosure obligations in relation to CPBs and emphasised that using the CPB should not trigger corporate governance actions or any other actions that would indicate to the market that they were using the CPB.

Our response:

Notifications

The CPB is based on forward-looking analysis. If a firm needs or expects that it will need to use the CPB, we would reasonably expect the firm to inform its supervisor in accordance with Principles for Business (PRIN 11). Where a firm contacts us in this situation, we would expect it to explain why it needs to use the CPB, including demonstrating that usage is due to adverse circumstances outside its normal and direct control. We would expect to discuss the firm's overall capital position, and be assured it can continue to meet its ICG on a forward-looking basis.

Therefore, where a firm identifies that adverse circumstances are likely to cause, or have caused, its capital resources to fall so its CPB would need to be used, it should:

- write to us clearly explaining the circumstances for this; and
- provide us with revised forward-looking capital plans, including a trajectory showing how the buffer is expected to be used over time and later restored.

After the firm has provided the information and we have reviewed it, we will, as appropriate, acknowledge that we agree with its analysis, and confirm that we are content that the CPB can be used for a period.

In general, as part of regularly monitoring its capital position, we expect a firm to notify its supervisor as early as possible when identifying that it would need to use its CPB to establish dialogue with its supervisor. However, we acknowledge the comments received to CP09/30 in which respondents requested clarification about using the CPB in adverse circumstances where it is not possible to notify supervisors in advance and obtain their agreement. In such circumstances, we would expect firms to notify us and provide us with information in accordance with the process outlined above as soon as practicably possible.

Where, following discussions with the firm, we are not satisfied with the explanation offered regarding the use of the CPB (e.g. because it arises from poor planning), we may take other supervisory actions. This could include asking the firm to rebuild its CPB. Although the CPB is not a minimum regulatory capital requirement, it serves to help firms to meet their minimum capital requirements at all times and therefore, actions may be necessary to ensure that the firm does not breach its minimum capital requirements in future. The nature and intensity of any actions will depend on the individual circumstances.

Circumstances under which the CPB may be used

In CP09/30, we stated that a firm may use its CPB to absorb losses or meet increased capital requirements that result from 'adverse external circumstances'. These include macroeconomic downturns, financial/market shocks or other adverse events arising from a deteriorating external environment or stressed conditions. These may include circumstances like those outlined in our supervisory recommended scenario. However, we note that this does not comprise an exhaustive set of adverse conditions. Therefore, due to the idiosyncratic nature of the CPB, there may be firm-specific circumstances where the CPB can also be used that relate to the specific risks the firm faces. For example, for some firms this may include specific market risk events.

Therefore, we are taking the opportunity in this PS to clarify our governing principle regarding the use of CPBs. CPBs are available for use in adverse circumstances that are outside the firm's normal and direct control – that is, the reason for using the CPB should be the result of circumstances that are outside of the firm's normal and direct control. For example, a firm should not draw down its CPB for purposes such as an acquisition.

Supervisory consequences of using the CPB

We acknowledge the concern raised by respondents to CP09/30 concerning terminology such as 'triggers' and/or 'heightened supervisory interaction'. By using this terminology, we did not intend to suggest that simply starting to use the CPB would result in the FSA taking direct supervisory intervention in the firm's business.

As a general principle, when a firm notifies us that it needs to use its CPB, this will not automatically mean direct supervisory intervention in the firm's business, as long as the CPB is being used due to adverse circumstances that are outside the firm's normal and direct control, rather than arising from mismanagement or poor planning. Where the CPB is being used in accordance with our guidance, we would normally expect to reach an agreement between ourselves and the firm about monitoring and plans for using the CPB further and/or rebuilding it. Obviously, concerning future trigger points, additional actions may be needed which will, of course, take into account the precise circumstances and we would seek to align our approach with the actions that we would expect the firm to take anyway as part of its own risk management processes. But to reiterate, we expect that, in general, such additional actions would not be taken as a result of first using its CPB, but would be related to any specific trigger points agreed in advance with the firm in respect of further use of the CPB.

Therefore, in general, using the CPB should be regarded as a starting point for dialogue between a firm and its supervisor about the firm's capital position, rather than as an automatic trigger for intervening in the firm's business.

Monitoring use of capital planning buffers

3.41 Respondents accepted that using the CPB would likely involve the need for additional reporting mechanisms to be put in place to monitor firms' use of the CPB in line with their capital plan.

3.42 It was requested that any reporting established in relation to the CPB should remain confidential between a firm and its supervisor, with some respondents requesting that such reporting be part of ongoing dialogue between a firm and its supervisor rather than presented in a formal template.

Our response: Firms are clearly responsible for monitoring their actual and potential use of the CPB. In addition to the firms' own monitoring, in acknowledging the firm's analysis about using the CPB, we may put additional reporting arrangements in place so we can regularly monitor using and re-building the CPB. This reporting would be shared between the firm and its supervisor. For ease, one standard mechanism for CPB reporting will be through the FSA003 regulatory return. More detail on the changes we propose to make to FSA003 relating to CPBs can be found in CP10/15.[15]

As noted, at the same time we may also agree specific future trigger points concerning the CPB as it is used up, which could lead to enhanced dialogue with the firm and potential supervisory actions. Any trigger points would be determined on a case by case basis between firms and their supervisors, taking account of the specific circumstances concerned.

Building and re-building capital planning buffers

3.43 Respondents asked for more clarity about how buffers would be set and would operate in times of economic downturn or periods of stress, where prevailing economic conditions suggested the economy was near the bottom of a cycle. They believed that CPBs identified during periods of stress should generally be lower compared to CPBs set during more benign periods.

3.44 Respondents also wanted clarification that we would not adopt a 'one size fits all' approach to restoring the CPB, but rather will take into account the firm's specific circumstances, sector and capital plan.

3.45 Some respondents were concerned that, in stating that 'we may, at times and under certain circumstances, identify a CPB that we would want a firm to hold in the future which should be built up over time' in CP09/30, we were indicating that we might set two CPBs for a firm, leading to double counting.

Our response: Our overarching objective for CPBs is that they are available for use, and indeed are used, in adverse circumstances that are outside the firm's normal and direct control. Therefore, the process by which a firm subsequently rebuilds its CPB is important. We conclude that restoring and rebuilding CPBs should be determined by the nature of the event that caused the firm to use its CPB. Therefore, one-off, idiosyncratic events may require faster restoration of the CPB, whereas using the CPB in, for example, prolonged deteriorations in economic conditions may mean we allow firms more time to gradually restore their buffer.

The specific trajectory for restoring the CPB will be discussed and agreed on a case by case basis between the firm and its supervisor, considering the firm's specific circumstances and the economic context at that time.

We note concerns raised by respondents about instances where CPBs are set during adverse periods, with particular regard to raising capital under adverse conditions and the risk of

15 CP10/15: Quarterly consultation No. 25 (www.fsa.gov.uk/pages/Library/Policy/CP/2010/10_15.shtml).

pro-cyclicality. However, we reiterate our position set out in PS09/20 and CP09/30, where we stated that the forward-looking scenarios used in capital planning stress tests should reflect new macroeconomic information and consequently should not result in CPBs that are automatically larger in a downturn and smaller in an upturn. Our view is that this approach to setting scenarios for capital planning stress tests will help avoid pro-cyclicality in setting CPBs in stressed conditions.

In addition, in some exceptional cases, should circumstances make this an appropriate response, we may identify a forward-looking target CPB that we would expect a firm to build up to over time. Where we identify this future target CPB, it will be clearly communicated as being distinct from the level of CPB we would expect the firm to hold initially. The timescale for meeting the target CPB would be agreed between firms and supervisors, considering the firm's specific circumstances and the economic context at that time.

Links with recovery and resolution plans ("RRPs")

3.46 Some respondents asked whether there was a link between using the CPB and RRPs, given the references in CP09/30 that using the CPB could result in heightened supervisory interaction, and the role of an RRP to improve a firm's financial resilience. More generally, respondents were concerned about the interaction between RRPs and the CPB framework and asked that, when setting CPBs, we recognise the robustness of a firm's recovery and resolution plans.

3.47 They also suggested there should be less regulatory emphasis on holding capital to prevent financial failure, and more on anticipating and managing the consequences of failure through initiatives such as RRPs, clarity over wind-down processes and a robust depositor protection scheme.

Our response: We agree that capital is not the sole means of preventing failure, and firms will note we are undertaking initiatives relating to non-capital mitigants such as RRPs to anticipate, and manage the consequences of, failure. It is important that firms understand the links and the differences between RRPs and capital measures such as the CPB.

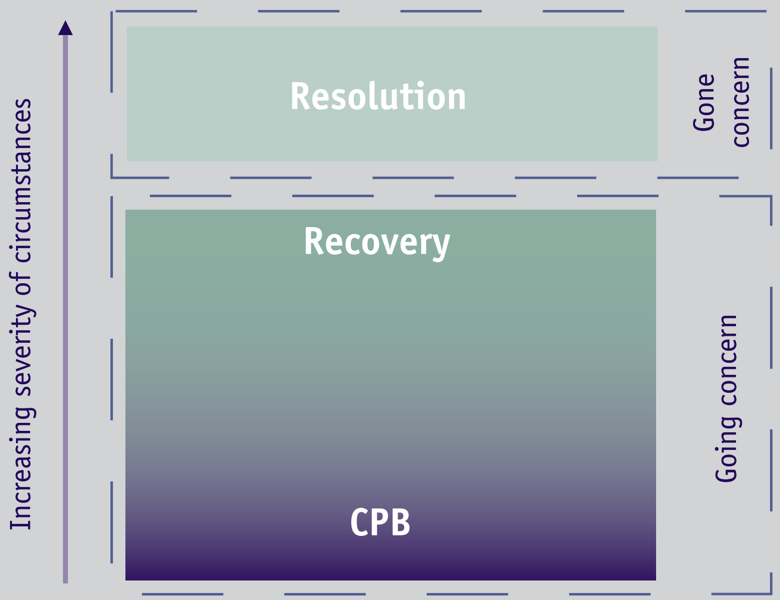
CPBs are designed to ensure that firms can meet the overall financial adequacy rule at all times, and so by definition only apply on a going concern basis and are expected to be used in adverse circumstances. The CPB framework is therefore distinct from RRPs. Recovery plans are for the firm to enact in order to prevent it from failing in the event of severe and extreme crisis events. Resolution plans provide information that is necessary to enable the authorities to resolve a failing firm in an orderly manner and reduce the impact of failure. Circumstances that would trigger the implementation of either a recovery or resolution plan would usually be unexpected and more severe than the circumstances that could typically lead a firm to propose use of its CPB. Therefore, while firms should note the potential interaction between RRPs and CPBs as the CPB is used up, it is important they understand the inherent differences between these two supervisory tools.

Firms may find the analysis from capital planning stress testing useful in informing development of recovery plans by facilitating consideration of the types of events or scenarios that may seriously affect them. Analysing and quantifying potential mitigating actions available to management, undertaken as part of a firm's analysis to determine its CPB, may also be useful to senior management in framing the more radical actions that could need to be included in the firm's recovery plan.

Recovery plans can be described as a credible, practicable and effective package of options a firm can use in cases of extreme crisis to help senior management reduce the probability of the firm failing. However, rather than focusing on avoiding the firm's outright failure, management actions proposed and quantified in capital planning stress tests are designed to help firms ensure they meet their regulatory capital requirements in a stressed situation. Therefore, we would expect there to be differences between the types and severity of management actions firms propose in capital planning stress testing which helps to set CPBs, and those proposed in recovery plans to deal with more severe and unanticipated events. For example, even if a firm proposed cost-cutting measures as a mitigating management action in its capital planning analysis as well as in its recovery plan, we would expect the severity of such measures to be much greater in the recovery plan, acknowledging the distinction between the purpose of CPBs and recovery plans.

Firms should also ensure the management actions proposed in capital planning analysis and those proposed in a recovery plan are consistent. For example, if a firm proposes specific measures to cut costs under stressed conditions as part of its capital planning analysis, we would expect the firm to recognise these specific measures as actions that would have already been taken by the time its recovery plan is enacted, so it can ensure the management actions proposed in both analyses are not 'double counted'.

Figure 2 – the CPB and RRPs



Specifying ICG or CPB in particular qualities of capital

3.48 In CP09/30, we explained that in our current framework (BIPRU 2.2.17G) we have various choices in setting ICG so we may set ICG on varying qualities of capital in individual cases. Therefore, we may articulate ICG as a combination of capital resources of varying amount, type and quality that we consider adequate for the firm to hold so they comply with GENPRU 1.2.26R.

3.49 Consequently we proposed some minor Handbook clarification to BIPRU 2.2 to clarify that we may at times, give guidance to firms specifying elements of the CPB or ICG to be held in particular qualities of capital (e.g. Core Tier 1) on a case by case basis. We would do so to ensure firms:

- can meet all relevant capital ratios in the supervisory framework at all points in the economic cycle; and
- have sufficient capital to absorb losses and meet increases in capital requirements in adverse external circumstances.

3.50 In making these clarifications, we explained we were not proposing new capital ratios or new definitions of capital. Instead, we were referring to capital ratios specified in our existing supervisory framework[16] and existing definitions of capital.

3.51 We asked:

> Q5: 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?

3.52 Several respondents confirmed they understood and accepted our proposed clarification. Following the experience of the recent market turmoil, there was support in particular for setting elements of the CPB as Core Tier 1 capital to absorb losses that could occur in such situations.

3.53 However, some questioned whether specifying the form of the CPB was a new requirement that would result in additional costs for firms. Others asked for further clarification about what qualities of capital we would specify, with some respondents concerned that we were creating new qualities of capital, saying that individual firms are best placed to decide on the form of capital in which their CPB is held. Respondents requested that firms be permitted to use existing eligible instruments as part of a CPB at the total capital level.

3.54 Respondents asked that, in taking this approach, we avoid being overly prescriptive and be mindful of the practicalities of restructuring capital instruments and raising capital over short periods of time. It was also suggested that our approach to specifying elements of the CPB in particular qualities of capital should take into consideration international developments in capital standards including changing the definitions of capital.

3.55 One respondent highlighted that the limits on the structure of capital imposed by GENPRU 2.2.29R do not apply to BIPRU investment firms. It was therefore suggested that we should consider the current regulatory limits imposed on such firms.

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

Our response: This proposal was included in CP09/30 to make our existing approach clear for firms, and does not represent a new requirement.

We wish to make clear and reassure firms that when we refer to 'particular qualities of capital' we only refer to existing regulatory capital instruments currently permitted in our framework (e.g. existing definitions of Core Tier 1 or Tier 1 capital). As respondents have highlighted, there are continuing discussions at national and international levels about prudential capital standards, including changes to the definitions of regulatory capital. We will take account of the final outcomes of these discussions in implementing this approach.

Although we note that firms will likely have their own view of the capital instruments they should hold as CPB, we are also aware of the clear regulatory focus on firms to hold higher quality capital. Therefore firms should be aware that we are likely to specify elements of the CPB in Core Tier 1 capital. We already do this in our existing Pillar 2 framework on a case by case basis, aiming to ensure that firms can meet all supervisory ratios they are measured against, including the interim capital regime[17] where this applies. We also aim to ensure firms hold sufficient levels of loss-absorbing capital so the CPB operates as intended.

For example, where a firm is monitored against the interim capital regime, in addition to the dialogue we would normally have with the firm about its ability to meet capital ratios in the regime, we may specify an amount of the CPB to be held in Core Tier 1 capital. This ensures the firm can continue meeting the 4% Core Tier 1 ratio it is measured against at all points in the cycle.

We will implement this approach case by case, taking into account the firm's specific circumstances, prevailing capital market conditions at that time and the practicalities involved in raising or changing the composition of capital instruments.

Contingent capital and capital planning buffers

3.56 One respondent said if we specify elements of the CPB or ICG to be held in particular qualities of capital, converting one form of capital to another to meet our specifications could affect investors and damage confidence in the firm. In particular, it was suggested that contingent capital which converts into Core Tier 1 after a trigger point could be interpreted as a sign of weakness and result in adverse market reactions. Another respondent highlighted the untested nature of convertible instruments and cautioned against their use in CPBs.

17 Note that firms would have been made aware of any supervisory ratios that they are measured against such as the interim capital regime outlined in the Financial Risk Outlook (www.fsa.gov.uk/pubs/plan/financial_risk_outlook_2010.pdf) or ICG and www.fsa.gov.uk/pages/Library/Communication/Statements/2008/capapp.shtml www.fsa.gov.uk/pages/Library/Communication/Statements/2009/bank_capital_.shtml.

Our response: The CPB exists so a firm can meet its regulatory capital requirements at all times and therefore maintain its going concern status. Consequently we expect CPBs to be composed of capital of sufficient quality to absorb losses and meet any potential increases in regulatory capital requirements so that the firm can meet its minimum capital requirements at all times.

Therefore, as the CPB is designed to help firms maintain their going concern status, we note the challenges of recognising contingent capital instruments in their contingent quality. Uncertainty about trigger activation and market reactions to conversion could undermine the purpose for which the buffer is held, (i.e. to ensure firms continue operating as normal). Therefore, we do not currently intend to recognise contingent instruments in CPBs in any form other than their pre-trigger quality. We accept there have been certain cases where contingent-like capital instruments have been accepted to meet stress test capital requirements. We note that when setting CPBs unusual circumstances may require a response which does not fit with our general approach. We are clear that these do not set a precedent to be used more generally. For example, we have taken specific decisions when necessary for mutuals that have restricted ability to issue Core Tier 1 capital instruments.

We also acknowledge there are continuing international discussions about the role of contingent capital. We may need to review our approach if an international consensus is reached on contingent capital that incorporates a solution for triggers, so that they do not undermine a given firm's going concern status.

Other issues raised by respondents to CP09/30

3.57 As well as the responses we received to the specific questions posed in CP09/30, we also received a range of other comments which we set out and respond to below.

Reissue of ICG letters

3.58 Respondents to CP09/30 requested clarification about whether we intend to re-issue ICG letters to firms following the clarifications proposed in CP09/30 to cover the ICG at a lower level by removing any buffer that is currently included in the ICG. In particular, respondents indicated their understanding that separate advice would be provided to firms on a recommended CPB. They said it would be unacceptable if capital requirements on firms through the ICG and the CPB were to increase following clarifications in CP09/30.

Our response: As stated in CP09/30, we intend to revise the wording used to articulate the ICG to a firm to reflect the clarifications in our policy approach and to make it clear that CPBs are not part of our view of adequate financial resources that must be maintained at all times. Instead, CPBs represent an amount that is available to use in adverse circumstances that are outside the firm's normal and direct control. The revised wording is set out in more detail in Section 4.2.

It should be noted that while in practice the CPB is being separated from our view of adequate financial resources a firm should hold at all times in accordance with GENPRU 1.2.26R, we do not expect the ICG figure articulated to firms, usually set as a percentage of Pillar 1, to change following the clarifications in our approach to CPBs. This is because a capital planning add-on set for a firm under our current regime is articulated as a separate absolute amount that is not included in the 'percentage of Pillar 1' figure. The CPB is not considered as part of a firm's ICG that must be held at all times but is available to use to absorb losses or meet increases in capital requirements in adverse circumstances, outside the firm's normal and direct control.

Where a firm has been issued with an ICG letter before CP09/30 was published, which has different wording to articulate the CPB compared to CP09/30 or Section 4.2 (e.g. where we have previously referred to the CPB as a 'capital planning add-on' to the ICG or any other variation), firms should note that our policy applies in the same way to those letters as it does to ICG letters issued now and in the future. In all cases, the CPB or capital planning add-on is an amount of capital that is available the firm to use in adverse circumstances that are outside its normal and direct control.

Therefore, we do not intend to re-issue ICG letters to all firms, and ask that where individual firms would like further clarity regarding the CPB they have been set in an existing ICG letter or clarification regarding its purpose, they should contact their supervisors directly to discuss this.

Transparency and clarity in identifying CPBs

3.59 Respondents requested transparency and clarity about the process used to set the CPB in order to assist firms' understanding of the calculation. They also requested agreement between the firm and its supervisor on the stress test results used to identify the CPB.

Our response: CPBs are identified using a combination of the analysis and calculation from the firm through its ICAAP and, in some cases, our own analysis to compare with the firm's submission. As is currently the case through our existing Pillar 2 framework, firms are expected to engage with their supervisors about the SREP process and calculating the firm's ICG and CPB. As part of this process, we expect firms to discuss their stress test results and how they relate to calculating the CPB with their supervisors.

Dynamic nature of the CPB

3.60 Respondents requested that the calculation of the CPB should be able to adjust with changes in business and economic circumstances, suggesting that communication of such changes could take place as part of a regular review process between the firm and its supervisor. It was suggested that if a dynamic approach is not taken, the CPB as set will always be out of date.

Our response: We expect that firms and supervisors will continue to engage in continuing dialogue in relation to changes in a firm's business and other matters. Therefore, although the ICG and the CPB would normally be reset as part of the SREP process, in the context of discussions, supervisors may in some cases consider whether the firm's ICG or CPB would need to be reset, outside of the firm's designated regulatory period.

The level at which the CPB is set

3.61 A number of respondents assumed that CPBs would be set at a group, rather than solo level. Respondents expressed a preference for setting CPBs at a group level in order to avoid duplication. It was suggested that firms could be able to allocate their CPB across entities in the group as appropriate according to circumstances.

Our response: The SREP is our general supervisory review of firms' risk management and prudential soundness. The ICG and CPB are set as part of this process, using the firm's analysis and our own.

We have not explicitly communicated that CPBs would only be set at group level, and since the measures in this PS seek to clarify rather than change our existing approach, our intention is that CPBs will continue to be set at the same level as the ICG, as would have been the case without the policy clarification set out in CP09/30.

Where considered appropriate given the particular circumstances of the firm or group in question, we may set the CPB at a different level (group or solo entity level) to the ICG.

Clarification between Pillar 1, Pillar 2A and Pillar 2B

3.62 Respondents requested clarity in relation to the distinction between Pillar 2A and Pillar 2B, suggesting that there is a lack of understanding about how the three elements of Pillar 1, Pillar 2A and Pillar 2B interact.

3.63 Respondents also asked for clarification regarding the purpose of capital being held under Pillar 1 and Pillar 2A given that the CPB is designed to be used in stress circumstances.

Our response: We acknowledge respondents' requests for clarification in relation to the interaction between Pillar 1, Pillar 2A and Pillar 2B.

An important element of our existing Pillar 2 framework is the forward-looking capital planning stress test that requires firms to demonstrate how they will meet the overall financial adequacy rule over a three to five year capital planning horizon. This requires a firm to project its capital resources and capital requirements through an economic or business cycle, to understand how changes in the external environment would affect the firm's ability to meet its regulatory capital requirements. Importantly, Pillar 2B stress tests are used to identify additional impacts on the firm's ability to meet its capital needs as a result of changes in the external environment that are over and above the amount of capital held by the firm against 12 months of unexpected losses (Pillar 1 and Pillar 2A). For example, a firm may identify changes in its risk profile, or changes in available capital resources as a result of impacts of the stress scenario through losses.

Scenarios for capital planning stress tests should be appropriately severe but plausible in accordance with guidance given in GENPRU 1.2.73A G. It remains individual firms' responsibility to develop their own scenarios that are relevant to their business for their capital planning stress tests. However in PS09/20, Stress and scenario testing, we added guidance in the Handbook about our expectations of the appropriate severity of these scenarios. In March 2010,[18] we published our first supervisory recommended scenario as an 'anchor' to guide firms' development of their own scenarios for capital planning stress tests. We intend to update the scenario periodically to reflect new macroeconomic information to ensure it remains relevant given the prevailing macroeconomic conditions. Some firms will also, at times, be asked to run specific scenarios that should be included in ICAAP submissions.

In response to requests for clarification with regard to when capital held under Pillar 1 and Pillar 2A might be used, we clarify that capital held in Pillar 1 and Pillar 2A is held to ensure firms always have adequate financial resources in relation to their business activities as required by GENPRU 1.2.26R. This capital, held in Pillar 1 and Pillar 2A, is therefore not available for use, as it is there to ensure that there is no significant risk that the firms' liabilities cannot be met as they fall due. This is clearly distinct from the purpose of the CPB (Pillar 2B), that can be used in adverse circumstances outside the firm's normal and direct control.

18 The high level parameters of our supervisory recommended scenario were published in the Financial Risk Outlook 2010 and on our stress testing webpages (www.fsa.gov.uk/Pages/About/What/International/stress_testing/firm_s/pillar_2_stress_testing/supervisory_recommended_scenarios/index.shtml).

4 Next steps

Revised wording for ICG letters

4.1 In CP09/30 we provided an example of the wording we might use to explain the ICG and CPB to a firm to make it clear that the CPB is not part of our view of adequate financial resources that must be maintained at all times, but rather, it is an amount that is available for use in adverse circumstances that are outside the firm's normal and direct control.

4.2 We set out a final version of the text below that will be used to communicate the ICG and CPB to a firm.

Final wording to articulate ICG and CPB in letters to firms

Individual Capital Guidance (ICG)

The detailed ICG for your firm is set out below:

- A minimum amount of capital of **xxx%** of your Pillar 1 requirement plus **£xx** as a static add-on (for [e.g. pension risk])

Please note that your firm should hold the minimum amount and quality of capital at all times. However, the ICG will become subject to review if any material changes to the firm were to occur.

Capital Planning Buffer (CPB)

Your firm should also hold an amount of **£y** as a CPB in excess of the amount of capital indicated above as the firm's ICG. The CPB has been set on the basis of the stress tests submitted by your firm and any stress tests conducted by the FSA.

The CPB is intended to ensure that your firm is able to withstand a stress scenario without breaching the overall financial adequacy rule (GENPRU 1.2.26R). We acknowledge that your firm may need to use some of this buffer over the capital planning period should adverse circumstances transpire. These should be circumstances beyond the firm's normal and direct control, whether relating to a deteriorating external environment or periods of stress, or the firm's specific circumstances.

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 on this basis, we would expect you to be able to demonstrate that the fall is due to adverse circumstances that are outside the firm's normal and direct control. We will require a clear action plan setting out how the firm will restore its CPB. For specific guidance on usage and monitoring of the CPB, see BIPRU 2.2.23G to 2.2.23FG.

CPB Reporting

4.3 In Section 3.41, we stated that we may put additional reporting arrangements in place so we can regularly monitor the use and rebuilding of the CPB. While some element of the reporting arrangements will be determined on a case by case basis between a firm and its supervisor, one mechanism we propose to use to enable regular monitoring of the CPB is the FSA003 regulatory return, which gives us information on the firm's solvency.

4.4 The form is intended to reflect the underlying prudential requirements contained in GENPRU and BIPRU and allows monitoring against the requirements set out there and any individual requirements placed on firms. Therefore, we think it is important that the return is aligned to our policy relating to CPBs as set out in this document, (i.e. including a separate field for reporting the CPB).

4.5 We therefore proposed a small number of changes to the FSA003, which will result in some small changes to firms' regulatory reporting and were consulted on separately.[19]

4.6 As the information contained within the FSA003 is treated as confidential, we remind firms that the form should not be shared for non-regulatory purposes.

19 The proposed changes to FSA 003 are outlined in CP10/15: *Quarterly consultation No. 25* (www.fsa.gov.uk/pages/Library/Policy/CP/2010/10_15.shtml).

List of non-confidential respondents to CP09/30

Association for Financial Markets in Europe/British Bankers' Association/International Swaps and Derivatives Association

Association of Private Client Investment Managers and Stockbrokers

Barclays Bank Plc

Bath Building Society

Building Societies Association

Investment Management Association

Lloyds Banking Group

Price Waterhouse Coopers LLP

Volterra Consulting Ltd

Annex 2

Capital planning buffers – case studies and examples

1. The following set of illustrative examples is designed to demonstrate the consistant approach that should be taken to calculate the capital planning buffer (CPB). One example focuses on using and monitoring the CPB.

2. These examples are not designed to predict or prescribe supervisory responses or actions, which will be determined on a case by case basis between a firm and its supervisor, taking into account the specific circumstances concerned. In addition, the examples that follow should not be viewed as exhaustive, as there are numerous patterns of projected capital resources and requirements that could arise.

3. The aim of the CPB is to ensure that firms can maintain capital resources on a continuing basis to meet minimum specified capital levels. This is secured by asking the firm to hold an amount currently to absorb losses and/or meet increases in capital requirements that may occur in adverse circumstances that are outside the firm's normal and direct control (e.g. an economic downturn).

4. For each example, we set out a brief description of the scenario, some high level outputs of capital planning stress test analysis which forms the basis for the capital planning buffer calculation and an accompanying graph to illustrate the stress test outputs. We have made several general assumptions in these examples for simplification as well as consistency purposes which we set out below.

- For the purpose of this exercise capital requirements and capital resources are projected for a medium-sized bank to maintain consistency with regard to the scale of risk weighted assets (RWA), the individual capital guidance (ICG) and the CPB.
- In all the examples in this annex, the stress scenario used is the FSA's supervisory recommended scenario.[1]
- 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 initial ICG only reflects the minimum Pillar 1 capital requirements adjusted for any additional capital relating to other material risks that are not accounted for in the Pillar

1 www.fsa.gov.uk/Pages/About/What/International/stress_testing/firm_s/pillar_2_stress_testing/supervisory_recommended_scenarios/index.shtml.

1 minimum. The forecast ICG is therefore an extrapolation of the initial ICG expressed as a fixed percentage of Pillar 1. For simplicity, we have assumed there is no risk that was required to be covered by a fixed nominal add-on.

- ICG and the CPB have been set in relation to total capital only. However in practice, we may specify elements of ICG or the CPB that should be held in particular qualities of capital.
- All data are adjusted for realistic, credible and quantified management actions.

5. As set out in CP09/30, the CPB 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.

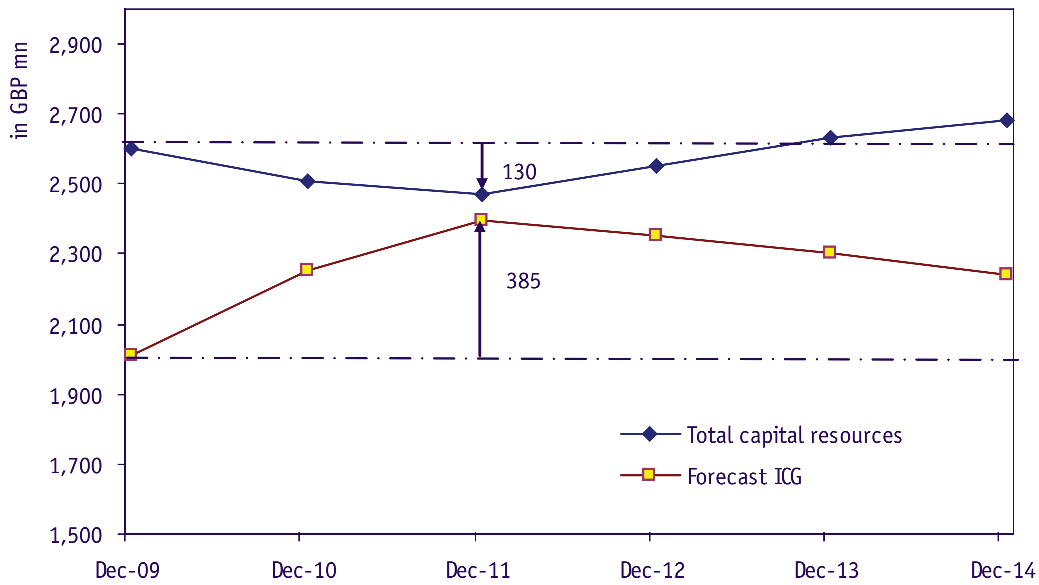
Example 1

6. This example represents a firm with a portfolio of assets that are directly affected as a result of changes in the economic cycle (e.g. a macroeconomic downturn). As the stress scenario crystallises, the firm's capital requirements are projected to increase, (e.g. as a result of rating migrations in the firm's portfolio of assets). Capital resources are projected to fall due to losses incurred over the stress period.

7. As economic conditions improve, capital requirements fall as a result of improvements in the quality of assets in the firm's portfolio and upwards rating migration of existing assets. Capital resources are also projected to increase as retained earnings improve.

8. Therefore, the capital planning buffer is set at £515m to reflect the movement in capital resources and capital requirements over the stress period so the capital is available to absorb losses and meet increasing capital requirements in adverse circumstances that are outside its normal and direct control.

ABC bank							
	Stress testing outputs						
	(All data adjusted for realistic management actions)	Dec-09	Dec-10	Dec-11	Dec-12	Dec-13	Dec-14
ICG calculation	**Capital requirements**						
	(£mn's)						
	RWAs	21,113	23,634	25,159	24,685	24,160	23,529
	Pillar 1 requirement	1,689	1,891	2,013	1,975	1,933	1,882
	Initial ICG	**2,010**					
	Forecast ICG	**2,010**	**2,250**	**2,395**	**2,350**	**2,300**	**2,240**
Capital	**Capital resources**						
	Initial total capital	**2,600**					
	Forecast total capital	**2,600**	**2,510**	**2,470**	**2,550**	**2,630**	**2,680**
CPB	**Capital planning buffer**						
	Movement in capital requirement (ICG) (A)	0	240	385	340	290	230
	Movement in capital resources (total capital) (B)	0	-90	-130	-50	30	80
	Difference ((A) - (B))	0	330	515	390	260	150
	Maximum difference (capital planning buffer)	**515**			***To be used during stress***		



Example 2

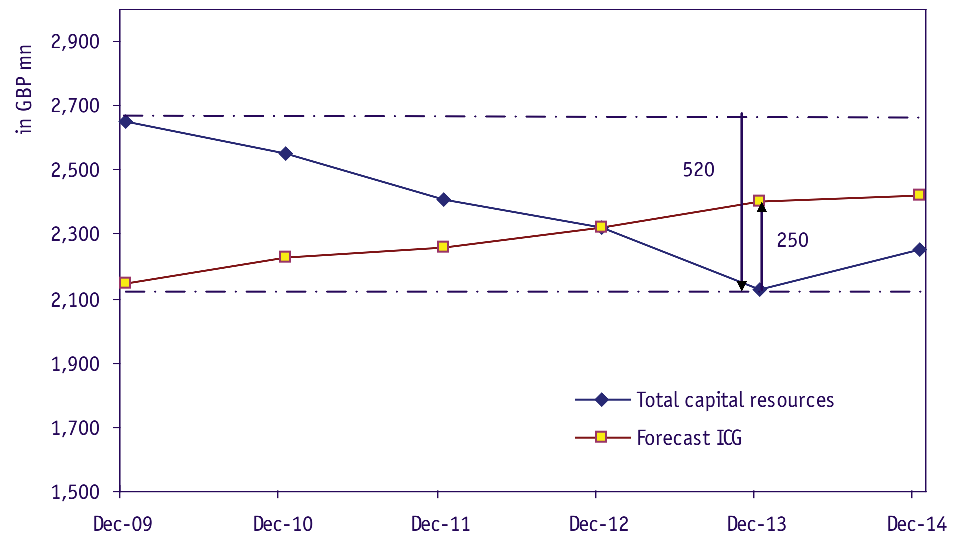
9. In this example, we consider a firm that operates a low quality portfolio of assets, perhaps as a result of taking on lower quality customers.

10. Therefore, under stressed conditions, the firm's capital requirements are projected to increase throughout the capital planning horizon. In addition, the firm's capital resources are projected to fall as a result of losses incurred as a result of the stress.

11. In this example, towards the end of the capital planning horizon, the firm projects a capital deficit in the stress with its capital requirements exceeding its capital resources. In this case, the projected deficit cannot be met from the firm's existing capital resources at the point of the CPB being set, so the firm will need to build its CPB, as we set out in section 3.43. This example assumes that the firm has considered all realistic and credible management actions to mitigate its deficit and has had dialogue with its supervisor in relation to the projected deficit.

12. Therefore, due to its objective as an amount of money set aside now to absorb losses or increases in capital requirements in a stress, the CPB would be calculated as £770m.

	ABC bank						
	Stress testing outputs						
	(All data adjusted for realistic management actions)	Dec-09	Dec-10	Dec-11	Dec-12	Dec-13	Dec-14
ICG calculation	**Capital requirements**						
	(£mn's)						
	RWAs	18,663	19,358	19,618	20,139	20,833	21,007
	Pillar 1 requirement	1,493	1,549	1,569	1,611	1,667	1,681
	Initial ICG	**2,150**					
	Forecast ICG	**2,150**	**2,230**	**2,260**	**2,320**	**2,400**	**2,420**
Capital	**Capital resources**						
	Initial total capital	**2,650**					
	Forecast total capital	**2,650**	**2,550**	**2,410**	**2,320**	**2,130**	**2,250**
CPB	**Capital planning buffer**						
	Movement in capital requirement (ICG) (A)	0	80	110	170	250	270
	Movement in capital resources (total capital) (B)	0	-100	-240	-330	-520	-400
	Difference ((A) - (B))	0	180	350	500	770	670
	Maximum difference (capital planning buffer)	**770**					
				To be used during stress			



Example 3

13. This example focuses on using and monitoring the CPB. It is purely hypothetical and for illustrative purposes only – therefore, the circumstances for the CPB's use, the trajectory of its use and subsequent supervisory actions should be viewed in that context only. In practice, the circumstances for using the CPB and the trajectory for its use will vary according to the individual firm. Any supervisory actions will be agreed between the firm and its supervisor on a case by case basis.

14. In this example, as a starting point, we have assumed that the capital planning buffer has been identified based on the output of the firm's capital planning stress test and has been set net of the effects of credible management actions. We have also assumed that the firm does not have capital resources exceeding the sum of its ICG and CPB.

15. At a point after the CPB is set, the firm experiences a stress that results in margin compression and increasing impairments. This is subsequently followed by a market shock. In response to these conditions, the firm's management have judged that the firm would need to use its CPB and notifies the firm's supervisors accordingly.

16. We then assume, for the purposes of this example that the firm's supervisors have agreed to the firm using the CPB in line with the trajectory they have presented. At this time, in accordance with the measures set out in this PS, we assume the supervisor has decided to put the following use and monitoring arrangements in place in relation to the CPB:

- If the firm's use of its CPB deviates from its planned trajectory by more than £xm on a cumulative basis, the firm should notify the supervisor to discuss the reasons for this

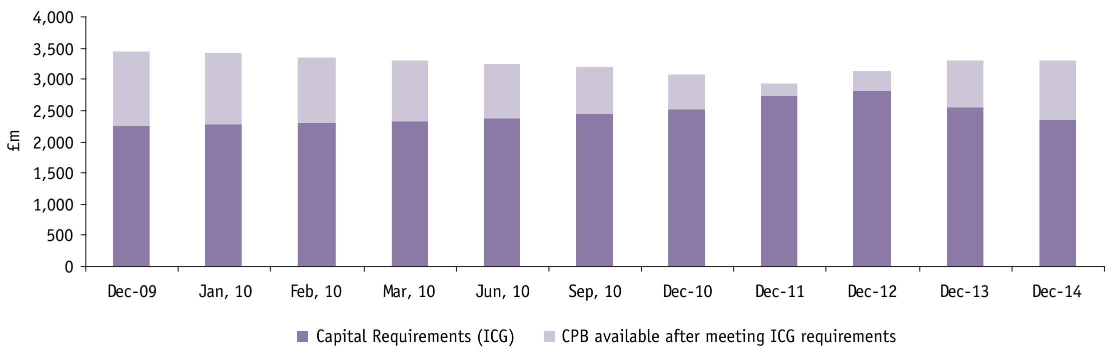
- The firm should provide its supervisor with analysis every y months setting out the actual (as opposed to expected) reasons for its use of the CPB for that period.

- In line with the firm's trajectory for using the CPB, the firm should provide the supervisor with monthly capital projections for the first three months of use followed by quarterly projections until December 2010 followed by yearly projections.

(N.B. The use and monitoring arrangements in this example are for illustrative purposes only. Note that in practice, use and monitoring arrangements will be determined on a case by case basis between the firm and its supervisor).

ABC bank											
Stress test scenario											
(All data adjusted for realistic management actions)	Dec-09	Jan, 10	Feb, 10	Mar, 10	Jun, 10	Sep, 10	Dec-10	Dec-11	Dec-12	Dec-13	Dec-14
Capital requirements											
(£mn's)											
Capital Requirements (ICG)	2,250	2,269	2,306	2,331	2,388	2,444	2,519	2,731	2,819	2,544	2,344
Capital resources											
Capital Planning Buffer	1,200										
Forecast total capital	3,450	3,409	3,344	3,296	3,246	3,191	3,079	2,941	3,139	3,294	3,294
CPB available after meeting ICG requirements	1,200	1,140	1,037	965	859	747	560	210	320	750	950
CPB utilisation	0	60	163	235	341	453	640	990	880	450	250

Projected CPB Usage



Handbook text

PRUDENTIAL REQUIREMENTS (CAPITAL PLANNING BUFFER) INSTRUMENT 2010

Powers exercised

A. The Financial Services Authority makes this instrument in the exercise of:

(1) the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):

(a) section 138 (General rule-making powers); and
(b) section 157(1) (Guidance);

(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 24 September 2010.

Amendments to the Handbook

D. The modules of the FSA's Handbook of rules and guidance listed in column (1) below are amended in accordance with the Annexes to this instrument listed in column (2).

(1)	(2)
Glossary of definitions	Annex A
General Prudential sourcebook (GENPRU)	Annex B
Prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU)	Annex C

Citation

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

By order of the Board
23 September 2010

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 adverse circumstances, after allowing for realistic management actions.

Amend the following as shown.

individual capital guidance .	*guidance* given to a *firm* about the amount and quality of capital resources that the *FSA* thinks the *firm* should hold <u>at all times</u> under the *overall financial adequacy rule* as it applies on a solo level or a consolidated level.

Annex B

Amendments to the General Prudential sourcebook (GENPRU)

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

1.2.16 G This section also has *rules* requiring a *firm* to carry out appropriate stress tests and scenario analyses for the risks it has previously identified and to establish the amount of financial resources needed in each of the circumstances and events considered in carrying out the stress tests and scenario analyses. In the case of a *BIPRU firm*, the *FSA* will consider as part of its *SREP* whether the *BIPRU firm* should hold a *capital planning buffer* and, in such a case, the amount and quality of that buffer. The *capital planning buffer* is an amount separate, though related to, the *individual capital guidance*, insofar as its purpose is to ensure that a *BIPRU firm* is able to continue to meet the *overall financial adequacy rule* throughout the relevant capital planning period in the face of adverse circumstances, after allowing for realistic management actions Therefore, when forming its view on a *BIPRU firm's capital planning buffer*, the *FSA* will take into account the assessment made in relation to the *firm*'s *ICG.*

…

1.2.19 G (1) …

(2) *BIPRU* 2.2 and *INSPRU* 7.1 also have information on how the *FSA* will review and respond to the assessments referred to in *GENPRU* 1.2.15 G and, in the case of *BIPRU firms*, in *GENPRU* 1.2.16G. In particular they deal with the giving of ~~individual capital~~ *individual capital guidance* to a *firm*, which is *guidance* about the amount and quality of capital resources that the *FSA* thinks a *firm* should hold at all times under the *overall financial adequacy rule* as it applies on a solo level and a consolidated level. *BIPRU* 2.2. also deals with the giving of a *capital planning buffer* to a *BIPRU firm* on a solo level and a consolidated level.

Annex C

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 *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 whether a *firm* should hold a *capital planning buffer* and, in that case, the amount and quality of such *capital planning buffer*. In making these assessments, the *FSA* will have regard to the nature, scale and complexity of a *firm*'s business and of the major sources of risks relevant to such business as referred to in the *general stress and scenario testing rule*. Accordingly, a firm's *capital planning buffer* should be of sufficient amount and adequate quality to allow the *firm* to continue to meet the *overall financial adequacy rule* in the face of adverse circumstances, after allowing for realistic management actions.

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*. The *FSA* may set *a firm's capital planning buffer* either as an amount and quality of capital which it should hold now (that is, at the time of the

FSA's notification following the *firm's SREP*) or, in exceptional cases, as a forward looking target that the *firm* should build up over time.

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 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*. In deciding whether it should use its powers under section 45, the *FSA* will take into account the amount and quality of the *capital planning buffer* which the *firm* should hold as referred to in *BIPRU* 2.2.12AG and 2.2.12BG. *SUP* 7 provides further information about the *FSA's* powers under section 45.

The drafting of individual capital guidance and capital planning buffer

2.2.16 G If the *FSA* gives *individual capital guidance* to a *firm*, the *FSA* will state what amount and quality of capital the *FSA* considers the *firm* needs to hold in order to comply with the *overall financial adequacy rule*. It will generally do so by saying that the *firm* should hold *capital resources* of an amount which is at least equal to a specified percentage of that *firm's capital resources requirement* plus one or more static add-ons in relation to specific risks in accordance with the *overall Pillar 2 rule*. ~~Such amount should be sufficient to enable the *firm* to continue to meet the *overall financial adequacy rule* in the face of the adverse circumstances and events to which GENPRU 1.2.42R(2) refers, taking account of any risk mitigation available to the *firm*.~~

…

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. This will normally be notified to the *firm* together with its *individual capital guidance* and expressed as a separate amount of *capital resources* that the *firm* should hold in excess of the amount of *capital resources* indicated as its *individual capital guidance*.

2.2.19B G For the purposes of *BIPRU* 2.2.19AG, *BIPRU* 2.2.17G to *BIPRU* 2.2.19G apply as they apply to *individual capital guidance*. References in those provisions to *individual capital guidance* or *guidance* should be read as if they were references to *capital planning buffer*. In relation to *BIPRU* 2.2.19G(3) and *GENPRU* 1.2.59R, where the *general stress and scenario testing rule*, as part of the *ICAAP rules*, applies to a *firm* on a consolidated basis, the *FSA* may notify the *firm* that it should hold a group *capital planning buffer*. In these cases, the *firm* should ensure that the group holds a *capital planning buffer* of sufficient amount and adequate quality to allow it to continue to meet the *overall financial adequacy rule* in the face of adverse circumstances, after allowing for realistic management actions.

…

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.~~ Monitoring the use of a *firm's capital planning buffer* is also a fundamental part of the *FSA's* supervision of that *firm*. A *firm* should only use its *capital planning buffer* to absorb losses or meet increased capital requirements if certain adverse circumstances materialise. These should be circumstances beyond the *firm's* normal and direct control, whether relating to a deteriorating external environment or periods of stress such as macroeconomic downturns or financial/market shocks, or firm-specific circumstances.

2.2.23A G Consistent with *Principle* 11 (Relations with regulators), a *firm* should notify the *FSA* as early as possible in advance where it has identified that it would need to use its *capital planning buffer*. The *firm*'s notification should at least state:

(1) what adverse circumstances are likely to force the *firm* to draw down its *capital planning buffer*;

(2) how the *capital planning buffer* will be 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.

2.2.23B G Following discussions with the *firm* on the items listed in BIPRU 2.2.23AG(1) to (3), the *FSA* may put in place additional reporting arrangements to monitor the *firm's* use of its *capital planning buffer* in accordance with the plan referred to in *BIPRU* 2.2.23AG(3). The *FSA* may also identify specific trigger points as the *capital planning buffer* is being used up by the *firm*, which could lead to additional supervisory actions.

2.2.23C G Where a *firm's capital planning buffer* is being drawn down due to circumstances other than those referred to in *BIPRU* 2.2.23G, such as poor planning or mismanagement, the *FSA* may ask the *firm* for more detailed plans for it to restore its *capital planning buffer*. In the light of the relevant circumstances, the *FSA* may consider taking other remedial actions, which may include using its powers under section 45 of the *Act* to vary on its own initiative a *firm's Part IV permission.*

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

2.2.23E G Where a *firm* has started to use its *capital planning buffer* in circumstances where it was not possible to notify in advance, it should notify the *FSA* and provide the information referred to in *BIPRU* 2.2.23AG as soon as practicable afterwards.

2.2.23F G *BIPRU* 2.2.20G to *BIPRU* 2.2.23EG 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))).

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