Prudential sourcebook for Investment Firms

Prudential sourcebook for Investment Firms

IFPRU 1 Application

1.1 Application and Purpose
1.2 Significant IFPRU firm
1.3 Supervisory benchmarking of internal approaches for calculating own funds requirements
1.4 EU CRR permissions
1.5 Notification of FINREP reporting
1.6 Actions for damages

IFPRU 2 Supervisory processes and governance

2.1 Application and purpose
2.2 Internal capital adequacy assessment process
2.3 Supervisory review and evaluation process: internal capital adequacy standards
2.4 Reporting of breaches
2.5 Recovery and resolution plans

IFPRU 3 Own funds

3.1 Base own funds requirement
3.2 Capital
3.3 Basel 1 floor

IFPRU 4 Credit risk

4.1 Application and purpose
4.2 Standardised approach
4.3 Guidance on internal ratings based approach: high level material
4.4 Internal ratings based approach: overall requirements for estimation
4.5 Internal ratings based approach: definition of default
4.6 Internal ratings based approach: probability of default
4.7 Internal ratings based approach: loss given default
4.8 Internal ratings based approach: own estimates of exposure at default (EAD)
4.9 Stress tests
4.10 Validation
4.11 Income-producing real estate portfolios
4.12 Securitisation
4.13 Settlement risk
4.14 Counterparty credit risk
4.15 Credit risk mitigation
4 Annex 1G 4 Annex 1G Slotting criteria

4 Annex 2G 4 Annex 2G Wholesale LGD and EAD framework

IFPRU 5 Operational risk

5.1 Application and purpose
5.2 Advanced Measurement Approach permission

IFPRU 6 Market risk

6.1 Market risk requirements
6.2 Guidance on market risk
6.3 Expectations relating to internal models

IFPRU 7 Liquidity

7.1 Application

IFPRU 8 Prudential consolidation and large exposures

8.1 Prudential consolidation
8.2 Large Exposures

IFPRU 9 Public disclosure

9.1 Application and Purpose

IFPRU 10 Capital buffers

10.1 Application
10.2 Capital conservation buffer
10.3 Countercyclical capital buffer
10.4 Capital conservation measures
10.5 Capital conservation plan
10.6 Application on an individual and consolidated basis
10.7 Exemption

IFPRU 11 Recovery and resolution

11.1 Application and purpose
11.2 Individual recovery plans
11.3 Group recovery plans
11.4 Information for resolution plans
11.5 Intra-group financial support
11.6 Contractual recognition of bail-in

11.7	Notifications
11 Annex 1	Recovery plans for significant IFPRU firms and group recovery plans for groups that include significant IFPRU firms
11 Annex 2	Information for resolution plans

Transitional provisions and Schedules

TP 1	GENPRU and BIPRU waivers: transitional
TP 3	Gains and losses
TP 4	Deductions from own funds
TP 5	Own funds: other transitionals
TP 6	Leverage
TP 7	Capital conservation buffer: transitional
TP 8	Countercyclical capital buffer: transitional
TP 9	Large exposures limits
Sch 1	Record-keeping requirements
Sch 2	Notification and reporting requirements
Sch 3	Fees and other requirement payments
Sch 4	Intentionally left blank
Sch 5	Rights of action for damages
Sch 6	Rules that can be waived

Chapter 1

Application

1

1.1 Application and Purpose

Application

1.1.1 G There is no overall application for *IFPRU*. Each chapter or section has its own application statement. However, *IFPRU* broadly applies in the following manner:

(1) only IFPRU 7 (Liquidity) and IFPRU 9 (Public disclosure) apply to an *exempt IFPRU commodities firm* and IFPRU 8.1 (Prudential consolidation) may apply subject to the conditions in that section; and

(1A) IFPRU 10 (Capital buffers) applies to an *IFPRU investment firm*, unless it is an:

(a) *exempt IFPRU commodities firm*; or

(b) *IFPRU limited-licence firm*; and

(2) other than in (1) and (1A), the whole of *IFPRU* applies to an *IFPRU investment firm*.

1.1.2 R *IFPRU* applies to a *firm* for the whole of its business, except where a particular provision provides for a narrower scope.

1.1.3 G (1) *IFPRU* applies to a *collective portfolio management investment firm* that is an *IFPRU investment firm* in parallel with IPRU(INV) 11 (see IPRU(INV) 11.6).

(2) Generally, *IFPRU* only applies to a *collective portfolio management investment firm's designated investment business* (excluding *managing an AIF* and *managing a UCITS*). However, IFPRU 2.2 (Internal capital adequacy assessment process) and IFPRU 2.3 (Supervisory review and evaluation process: Internal capital adequacy standards) apply to the whole of its business.

Purpose

1.1.4 G (1) The purpose of *IFPRU* is to implement, in part, *CRD* and certain national discretions afforded to the *FCA* as *competent authority* under *EU CRR*.

(2) Save as provided in the *Glossary*, any expression in the *Handbook* for the purpose of *IFPRU* which is defined or used in *EU CRR* shall have the meaning given by, or used in, those Regulations.

1

Exclusion of certain types of firms

1.1.5 R None of the following is an *IFPRU investment firm*:

(1) an *incoming EEA firm*;

(2) an *incoming Treaty firm*;

(3) any other *overseas firm*;

(4) a *designated investment firm*;

(5) a *BIPRU firm*;

(6) an *insurer*; and

(7) an *ICVC*.

Types of IFPRU investment firm

1.1.6 R An *IFPRU investment firm* includes a *collective portfolio management investment firm* that is not excluded under IFPRU 1.1.5 R (Exclusion of certain types of firms).

1.1.7 G In accordance with articles 95 and 96 of *EU CRR*, *IFPRU investment firms* are divided into the following categories:

(1) full-scope IFPRU investment firm;

(2) IFPRU limited licence firm; and

(3) IFPRU limited activity firm.

Alternative classification of IFPRU investment firms

1.1.8 R *IFPRU investment firms* are divided into the following classes for the calculation of the *base own funds requirement* and any other provision of the *Handbook* that applies this classification:

(1) an *IFPRU 50K firm*;

(2) an *IFPRU 125K firm*;

(3) an *IFPRU 730K firm*; and

(4) a *collective portfolio management investment firm*.

Types of IFPRU investment firm: IFPRU 125K firm

1.1.9 R An *IFPRU 125K firm* means an *IFPRU investment firm* that satisfies the following conditions:

(1) it does not:

(a) deal on own account; or

1

(b) underwrite issues of *financial instruments* (as referred to in Section A of Annex I of *MiFID*) on a firm commitment basis;

(2) it holds clients' money or securities for *investment services* it provides or is authorised to do so;

(3) it offers one or more of the following services (all as referred to in Section A of Annex I of *MiFID*):

(a) reception and transmission of investors' orders for *financial instruments*; or

(b) the execution of investors' orders for *financial instruments*; or

(c) the management of individual portfolios of investments in *financial instruments*;

(4) it is not a *collective portfolio management investment firm*; and

(5) it does not operate either a *multilateral trading facility* or an *organised trading facility*, or both.

[**Note**: article 29(1) of *CRD*]

Types of IFPRU investment firm: IFPRU 50K firm

1.1.10 R An *IFPRU 50K firm* is a *IFPRU investment firm* that satisfies the following conditions:

(1) the conditions in IFPRU 1.1.9 R(1) and (3);

(2) it does not hold clients' money or securities for *investment services* it provides and is not authorised to do so;

(3) it is not a *collective portfolio management investment firm*; and

(4) it does not operate either a *multilateral trading facility* or an *organised trading facility*, or both.

[**Note**: article 29(3) of *CRD*]

Types of IFPRU investment firm: IFPRU 730K firm

1.1.11 R (1) An *IFPRU investment firm* that is not a *collective portfolio management investment firm*, an *IFPRU 125K firm* or an *IFPRU 50K firm* is an *IFPRU 730K firm*.

(2) An *IFPRU investment firm* that operates either a *multilateral trading facility* or an *organised trading facility* or both is an *IFPRU 730K firm*.

[**Note**: article 28(2) of *CRD*]

Meaning of dealing on own account

1.1.12 R (1) For the purpose of *IFPRU* and the *EU CRR*, dealing on own account means the service of dealing in any *financial instruments* for own account as referred to in point 3 of Section A of Annex I to *MiFID*, subject to (2) and (3).

(2) In accordance with article 29(2) of *CRD* (Definition of dealing on own account), an *investment firm* that executes investors' orders for *financial instruments* and holds such *financial instruments* for its own account does not, for that reason, deal on own account if the following conditions are met:

(a) such *position* only arise as a result of the *investment firm's* failure to match investors' orders precisely;

(b) the total market value of all such *positions* is no higher than 15% of the *investment firm's initial capital*;

(c) (for an *investment firm* that is an *IFPRU investment firm* or an *EEA firm*) it complies with the requirements in articles 92 to 95 (Own funds requirements for investment firms with limited authorisation to provide investment services) and Part Four (Large exposures) of the *EU CRR*;

(d) (for any other *investment firm*) it would comply with the requirements in (2)(c) if it had been an *investment firm* on the basis of the assumptions in IFPRU 1.1.13 G (1)(a) and (b); and

(e) such *positions* are incidental and provisional in nature and strictly limited to the time required to carry out the transaction in question.

(3) In accordance with article 29(4) of *CRD*, the holding on non-trading book positions in financial instruments in order to invest in *own funds* is not dealing on own account for the purposes of IFPRU 1.1.9 R (Types of IFPRU investment firm: IFPRU 125K firm) and IFPRU 1.1.10 R (Types of IFPRU investment firm: IFPRU 50K firm).

Interpretation of the definition of types of firm and undertaking

1.1.13 G A *firm* whose head office is not in an *EEA State* is an *investment firm* if it would have been subject to the requirements imposed by *MiFID* (but it is not a *bank*, *building society*, *credit institution*, *local firm*, *exempt CAD firm* and *BIPRU firm*) if:

(1) its head office had been in an *EEA State*; and

(2) it had carried on all its business in the *EEA* and had obtained whatever authorisations for doing so as are required under *MiFID*.

1.1.14 G A *firm* also falls into one of the categories of an *IFPRU investment firm* listed in IFPRU 1.1.7 G (Types of IFPRU investment firm) or IFPRU 1.1.8 R (Alternative classification of IFPRU investment firms) if its *Part 4A permission* contains a *requirement* that it must comply with the *rules* in *IFPRU* applicable to that category of *firm*. If a *firm* is subject to such a *requirement*, and it would otherwise also fall into another category of *IFPRU investment firm*, it does not fall into that other category.

1.1.15 G For the purposes of the definitions in *IFPRU* and Part Three, Title I, Chapter 1, Section 2 of the *EU CRR* (Own funds requirements for investment firms with limited authorisation to provide investment services), a *person* does any of the activities referred to in *IFPRU* and the *EU CRR* if:

(1) it does that activity anywhere in the world; or

(2) its *permission* includes that activity; or

(3) (for an *EEA firm*) it is authorised by its *Home State regulator* to do that activity; or

(4) (if the carrying on of that activity is prohibited in a state or territory without an authorisation in that state or territory) that *firm* has such an authorisation.

1.1.16 G For the purposes of the definitions in *IFPRU* and Part Three, Title I, Chapter 1, Section 2 of the *EU CRR* (Own funds requirements for investment firms with limited authorisation to provide investment services), a *person* offers any of the services referred to in articles 95 and 96 of the *EU CRR* (Own funds requirements for investment firms with limited authorisation to provide investment services) if:

(1) it offers that service anywhere in the world; or

(2) any of IFPRU 1.1.15 G(1) to (4) apply.

1.1.17 G For the purposes of the definitions in *IFPRU* and Part Three, Title I, Chapter 1, Section 2 of the *EU CRR* (Own funds requirements for investment firms with limited authorisation to provide investment services), a *person* has an authorisation to do any of the activities referred to in articles 95 and 96 of the EU CRR (Own funds requirements for investment firms with limited authorisation to provide investment services) if any of IFPRU 1.1.15 G(1) to (4) apply.

1

1.2 Significant IFPRU firm

Purpose

1.2.1 G Throughout *CRD* and the *EU CRR* there are various policies which have restricted application based on a *firm's* scope, nature, scale, internal organisation and complexity. These policies are provided in the following:

(1) article 76 of *CRD* on the establishment of an independent risk committee;

(2) article 88 of *CRD* on the establishment of an independent nominations committee;

(3) article 91 of *CRD* on the limitations on the number of directorships an individual may hold;

(4) article 95 of *CRD* on the establishment of an independent remuneration committee;

(5) article 100 of *CRD* on supervisory stress testing to facilitate the *SREP* under article 97 of *CRD*;

(6) articles 129 and 130 of *CRD* on applicability of the capital conservation buffer and the countercyclical capital buffer (provided that an exemption from the application of these articles does not threaten the stability of the financial system of the *EEA State*);

(7) article 6(4) of the *EU CRR* on the scope of liquidity reporting on an individual basis;

(8) article 11(3) of the *EU CRR* on the scope of liquidity reporting on a consolidated basis; and

(9) article 450 of the *EU CRR* on disclosure on *remuneration*.

1.2.2 G The articles in ■ IFPRU 1.2.1 G do not always carry the same wording in describing what may be significant in terms of a *firm's* scope, nature, scale, internal organisation and complexity, but the articles have a general policy to restrict the application of those requirements to *institutions* which pose higher risks by virtue of broadly their size, types of business and complexity of activities. The *FCA*'s policy is to apply an objective definition with pre-defined thresholds to determine which *firms* are considered as significant for the purpose of these articles. In order to clarify which *firms* these policies apply to, ■ IFPRU 1.2.3 R defines the factors which determine if a *firm* is a *significant IFPRU firm*.

1

Definition of significant IFPRU firm

1.2.3 R A *firm* is a *significant IFPRU firm* if it meets, at any time, one or more of the following conditions:

(1) its total assets exceeds £530 million;

(2) its total liabilities exceeds £380 million;

(3) the annual fees and commission income it receives in relation to the *regulated activities* carried on by the *firm* exceeds £160 million in the 12-*month* period immediately preceding the date the *firm* carries out the assessment under this *rule* on a rolling basis;

(4) the *client money* that it receives or holds exceeds £425 million; and

(5) the assets belonging to its *clients* that it holds in the course of, or connected with, its *regulated activities* exceeds £7.8 billion.

1.2.4 R (1) This *rule* defines some of the terms used in IFPRU 1.2.3 R.

(2) "Total assets" means the *firm*'s total assets

(a) set out in the most recent relevant report submitted to the *FCA* under SUP 16.12 (Integrated regulatory reporting); or

(b) (where the *firm* carries out the assessment under this *rule* at any time after the date of its most recent report in (a)) as the *firm* would report to the *FCA* in accordance with the relevant report, as if the reporting period for that report ends on the date the assessment is carried out.

(3) "Total liabilities" means the *firm*'s total liabilities:

(a) set out in the most recent relevant report submitted to the *FCA* under SUP 16.12 (Integrated regulatory reporting); or

(b) (where the *firm* carries out the assessment under this *rule* at any time after the date of its most recent report in (a)) as the *firm* would report to the *FCA* in accordance with the relevant report, as if the reporting period for that report ends on the date the assessment is carried out.

(4) The *client money* means the *money* that a *firm* receives or holds in the course of, or in connection with, all of the *regulated activities* defined in paragraphs (1) to (4) of the *Glossary* that it carries on:

(a) as set out in the most recent client money and client asset report submitted to the *FCA* under *SUP*, as applies to the *firm* in SUP 16.12 (Integrated regulatory reporting); or

(b) (where the *firm* carries out the assessment under this *rule* at any time after the date of its most recent report in (a)) as the *firm* would report to the *FCA* in accordance with the relevant report, as if the reporting period for that report ends on the date the assessment is carried out.

(5) "Assets belonging to its *clients*" means the assets to which the custody rules apply:

(a) as set out in the most recent client money and client asset report submitted to the *FCA* under *SUP*, as applies to the firm in SUP 16.12 (Integrated regulatory reporting); or

(b) (if the *firm* carries out the assessment under this *rule* at any time after the date of its most recent report in (a)) as the *firm* would report to the *FCA* in accordance with the relevant report, as if the reporting period for that report ends on the date the assessment is carried out.

1.2.5 R A *firm* must regularly assess whether it, at any time, becomes a *significant IFPRU firm*.

1.2.6 R

(1) If a *firm*, at any time, becomes aware that it is likely to become a *significant IFPRU firm*, it must forthwith make arrangements to establish and have in place sound, effective and comprehensive strategies, processes and systems to achieve compliance with the requirements that apply to a *significant IFPRU firm*.

(2) The *firm* in (1) must comply with the requirements that apply to a *significant IFPRU firm* on the expiry of a period of three *months* from the date it meets any one of the conditions in IFPRU 1.2.3 R.

1.2.7 R If a *firm* that is a *significant IFPRU firm* ceases to meet any of the conditions in IFPRU 1.2.3 R, it must continue to comply with the *rules* and requirements applicable to a *significant IFPRU firm* until the first anniversary of the date on which the *firm* ceased to be a *significant IFPRU firm*.

1.2.8 G The *FCA* may, on a case-by-case basis, require a *firm* which does not meet any of the conditions in IFPRU 1.2.3 R to comply with the *rules* and requirements that apply to a *significant IFPRU firm* if the *FCA* considers it appropriate to do so to meet its strategic objective or to advance one or more of its operational objectives under the *Act*.

1.2.9 G

(1) A *firm* may apply to the *FCA* under section 138A of the *Act* to waive any one or more of the conditions in IFPRU 1.2.3 R if it believes that one or more of the governance requirements in (2) that apply to a *significant IFPRU firm* may be disproportionate to it. In its application for such *waiver*, the *FCA* expects the *firm* to demonstrate, taking into account size, nature, scope and complexity of its activities in the context of it being a member of a *group* and the internal organisation of the *group*, that it should not be considered as significant.

(2) The governance requirements referred to in (1) are:

(a) SYSC 4.3A.6 R on the limitations in the number of directorships; or

(b) SYSC 4.3A.8 R on the nomination committee; or

(c) SYSC 7.1.18 R on the risk committee; or

(d) SYSC 19A.3.12 R on the remuneration committee.

(3) The effect of such *waiver* is that the *firm* would not be a *significant IFPRU firm* only for the purpose of the particular governance requirement in (2) that the *waiver* is expressed to apply to. For the avoidance of doubt, such *firm* would still be a *significant IFPRU firm* for the purpose of the other *rules* in the *FCA Handbook* that apply to a *significant IFPRU firm*.

1.3 Supervisory benchmarking of internal approaches for calculating own funds requirements

1.3.1 R Except for *operational risk*, a *firm* that is permitted to use *internal approaches* for the calculation of risk weighted exposure amounts or own fund requirements must report annually to the *FCA*:

(1) the results of the calculations of its *internal approaches* for its *exposures* or positions that are included in the benchmark portfolios; and

(2) an explanation of the methodologies used to produce those calculations in (1).

[**Note**: article 78(1) of *CRD*]

1.3.2 G A *firm* must submit the results of the calculations referred to in IFPRU 1.3.1 R (1), in line with the template set out in the Commission Regulation adopted under article 78(8) of *CRD*, to the *FCA* and to EBA.

1.3.3 R Where the *FCA* has chosen to develop specific portfolios in accordance with article 78(2) of *CRD*, a *firm* must report the results of the calculations separately from the results of the calculations for EBA portfolios.

[**Note**: article 78(2) of *CRD*]

1.4 EU CRR permissions

1.4.1 R A *firm* which has applied for, or has been granted, a permission under the *EU CRR* must notify the *FCA* immediately if it becomes aware of any matter which could affect the continuing relevance or appropriateness of the application or permission.

1.4.2 G The reference to 'permission' in IFPRU 1.4.1 R includes any approval, consent or agreement referred to under the *EU CRR* for which the *FCA* has been conferred powers as *competent authority* by the *EU CRR*.

1.5 Notification of FINREP reporting

1.5.1 **R** An *IFPRU investment firm* must notify the *FCA*:

(1) if it is, or becomes, a *FINREP firm*; and

(2) when it ceases to be a *FINREP firm*.

1.5.2 **R** A *firm* must notify the *FCA* if it adjusts its *firm's accounting reference date* under the Commission Regulation made under article 99 of the *EU CRR*.

1

1.6 Actions for damages

1.6.1 R A contravention of the *rules* in *IFPRU* does not give rise to a right of action by a *private person* under section 138D of the *Act* (and each of those *rules* is specified under section 138D(3) of the *Act* as a provision given rise to no such right of action).

Chapter 2

Supervisory processes and governance

2

2.1 Application and purpose

[**Note**: On 19 December 2014, the *EBA* published guidelines on common procedures and methodologies for the supervisory review and evaluation process. The *FCA* has confirmed its intention to make every effort to comply with these guidelines that can be found at: http://www.eba.europa.eu/documents/10180/935249/EBA-GL-2014-13+%28Guidelines+on+SREP+methodologies+and+processes%29.pdf/.]

Application

2.1.1 R IFPRU 2 applies in the following manner:

(1) to an *IFPRU investment firm*, unless it is an *exempt IFPRU commodities firm*; and

(2) the *general stress and scenario testing rule* (and related *rules* and *guidance*) applies only to a *significant IFPRU firm*.

Purpose

2.1.2 G This chapter implements certain provisions of CRD relating to governance and contains *guidance* related to Section III of Chapter 2, Title VII of CRD (Supervisory review and evaluation process).

2.1.3 G This section amplifies Principle 4, under which a *firm* must maintain adequate financial resources. It is concerned with the adequacy of the financial resources that a *firm* needs to hold in order to meet its liabilities as they fall due. These resources include both capital and liquidity resources.

2.1.4 G This section has *rules* requiring a *firm* to identify and assess risks to its ability to meet its liabilities as they fall due, how it intends to deal with those risks, and the amount and nature of financial resources that the *firm* considers necessary. IFPRU 2.2.43 R (Documentation of risk assessment) provides that a firm should document that assessment. The *FCA* will review that assessment as part of its own assessment of the adequacy of a *firm's* capital under its supervisory review and evaluation process (*SREP*). When forming a view of any *individual capital guidance* to be given to the *firm*, the *FCA* will also review the regulator's risk assessment and any other issues arising from day-to-day supervision.

2.1.5 G This section 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 and internal capital needed in each of the circumstances and events considered in that analyses. The *FCA* will consider, as part of its *SREP*, whether the *firm* should hold a *capital planning buffer* and the amount and quality of that buffer. The *capital planning buffer* is an amount separate, though related to, the *individual capital guidance* in so far as its purpose is to ensure that a *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 *firm's capital planning buffer*, the *FCA* will take into account the assessment made in relation to the *firm's ICG*.

2.1.6 G This section has *rules* on the individual, *sub-consolidated basis* and *consolidated basis* application of:

(1) the *ICAAP rules* in IFPRU 2.2.45R to IFPRU 2.2.49R (Level of application: ICAAP rules);

(2) the *risk control rules* in IFPRU 2.2.58R to IFPRU 2.2.60R (Level of application: risk control rules); and

(3) the overall financial adequacy rule in IFPRU 2.2.61R to IFPRU 2.2.63R (Level of application: overall financial adequacy rule).

2

2.2 Internal capital adequacy assessment process

Adequacy of financial resources

2.2.1 R A *firm* must, at all times, maintain overall financial resources and internal capital, including *own funds* and liquidity resources which are adequate both as to amount and quality to ensure there is no significant risk that its liabilities cannot be met as they fall due.

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

2.2.3 G The effective management of prudential risk relies on the adequacy of a *firm*'s financial resources, systems and controls. These need to be assessed in relation to all the activities of the *firm* and the risks to which they give rise, and so this chapter applies to a *firm* for the whole of its business. For a *collective portfolio management investment firm*, this means that this section also applies to its activities in relation to the management of *AIFs* and/or *UCITS*.

2.2.4 G The liabilities referred to in the *overall financial adequacy rule*:

(1) include:

(a) a *firm*'s contingent and prospective liabilities;

(b) liabilities or costs that arise in scenarios where the *firm* is a going concern and those where the *firm* ceases to be a going concern;

(c) claims that could be made against a *firm*, which ought to be paid in accordance with fair treatment of *customers*, even if such claims could not be legally enforced; and

(d) claims on insurance that a *firm* has made or is in the course of making; and

(2) exclude liabilities that might arise from transactions that a *firm* has not entered into and which it could avoid (e.g. by taking realistic management actions such as ceasing to transact new business after a suitable period of time has elapsed).

2.2.5 G In the light of IFPRU 2.2.4 G, a *firm* should make its assessment of adequate financial resources on realistic valuation bases for assets and liabilities, taking into account the actual amounts and timing of cash flows under realistic adverse projections.

2.2.6 G Risks may be addressed through holding capital to absorb losses that unexpectedly materialise. The ability to pay liabilities as they fall due also requires liquidity. Therefore, in assessing the adequacy of a *firm's* financial resources, both capital and liquidity needs should be considered. A *firm* should also consider the quality of its financial resources, such as the loss-absorbency of different types of capital and the time required to liquidate different types of asset.

Strategies, processes and systems

2.2.7 R A *firm* must have in place sound, effective and comprehensive strategies, processes and systems:

(1) to assess and maintain, on an ongoing basis, the amounts, types and distribution of financial resources, *own funds* 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*;

(c) the risk that the *firm* might not be able to meet the obligations in Part Three of the *EU CRR* (Capital Requirements) in the future; and

(2) that enable it to identify and manage the major sources of risks referred to in (1), including the major sources of risk in each of the following categories where they are relevant to the *firm* given the nature and scale of its business:

(a) credit and counterparty risk;

(b) market risk;

(c) liquidity risk;

(d) operational risk;

(e) concentration risk;

(f) residual risk;

(g) securitisation risk;

(h) business risk;

(i) interest rate risk, including interest-rate risk in the non-*trading book*;

(j) risk of excessive leverage;

(k) pension obligation risk; and

(l) group risk.

[**Note:** article 73 first paragraph and article 74(1) of *CRD*]

2.2.8 R

(1) This *rule* defines some of the terms used in the *overall Pillar 2 rule*.

(2) Residual risk means the risk that *credit risk mitigation* techniques used by the *firm* prove less effective than expected.

(3) *Securitisation* risk includes the risk that the *own funds* held by a *firm* for assets which it has *securitised* are inadequate having regard to the economic substance of the transaction, including the degree of risk transfer achieved.

(4) Business risk means any risk to a *firm* arising from:

(a) changes in its business, including:

(i) the acute risk to earnings posed by falling or volatile income;

(ii) the broader risk of a *firm's* business model or strategy proving inappropriate due to macro-economic, geopolitical, industry, regulatory or other factors; and

(iii) the risk that a *firm* may not be able to carry out its business plan and desired strategy; and

(b) its remuneration policy (see also the *Remuneration Code* which applies to *IFPRU investment firms* and the detailed application of which is set out in SYSC 19A.1).

(5) Pension obligation risk is the risk to a *firm* caused by its contractual or other liabilities to, or with respect to, a pension scheme (whether established for its employees or those of a related *company* or otherwise). It also means the risk that the *firm* will make payments or other contribution to, or with respect to, a pension scheme because of a moral obligation or because the *firm* considers that it needs to do so for some other reason.

(6) Interest-rate risk in the non-*trading book* means:

(a) risks related to the mismatch of re-pricing of assets and liabilities and off balance sheet short- and long-term positions ("re-pricing risk");

(b) risks arising from hedging exposure to one interest rate with exposure to a rate which re-prices under slightly different conditions ("basis risk");

(c) risk related to the uncertainties of occurrence of transactions, for example, when expected future transactions do not equal the actual transactions ("pipeline risk"); and

(d) risks arising from consumers redeeming fixed rate products when market rates change ("optionality risk").

(7) Group risk is the risk that the financial position of a *firm* may be adversely affected by its relationships (financial or non-financial) with other entities in the same *group* or by risks which may affect the financial position of the whole *group* (eg, reputational contagion).

2.2.9 G

(1) This paragraph gives *guidance* on some of the terms used in the *overall Pillar 2 rule*.

(2) In a narrow sense, business risk is the risk to a *firm* that it suffers losses because its income falls or is volatile relative to its fixed cost base. However, in a broader sense, it is exposure to a wide range of macro-economic, geopolitical, industry, regulatory and other external risks that might deflect a *firm* from its desired strategy and business plan. IFPRU 2.3.47 G to IFPRU 2.3.54 G provides further *guidance* on business risk.

(3) Interest-rate risk in the non-*trading book* is explained in IFPRU 2.3.39 G (Interest rate risk in the non-trading book).

2.2.10 G In the *overall Pillar 2 rule*, internal capital refers to the financial resources of a *firm* which it treats as being held against the risks listed in the *overall Pillar 2 rule*. The obligation in that *rule* to assess the distribution of such capital refers, in relation to a *firm* making an assessment on an individualbasis, for example, to the need to take account of circumstances where part of a *firm*'s financial resources are held by a *branch* of that *firm* which are subject to restrictions on its ability to transfer that capital. An assessment of internal capital distribution might also take account of such of a *firm*'s financial resources as may be ring-fenced in the event of its insolvency.

2.2.11 R As part of its obligations under the *overall Pillar 2 rule*, a *firm* must identify separately the amount of *common equity tier 1 capital*, *additional tier 1 capital* and *tier 2 capital* and each category of capital (if any) that is not eligible to form part of its *own funds* which it considers adequate for the purposes described in the *overall Pillar 2 rule*.

2.2.12 R The processes, strategies and systems required by the *overall Pillar 2 rule* must be comprehensive and proportionate to the nature, scale and complexity of the *firm's* activities.

[**Note:** article 73 second paragraph (part) of *CRD*]

2.2.13 R A *firm* must:

(1) carry out regularly the assessments required by the *overall Pillar 2 rule*; and

(2) carry out regular assessments of the processes, strategies and systems required by the *overall Pillar 2 rule* to ensure that they remain comprehensive and proportionate to the nature, scale and complexity of the *firm's* activities.

[**Note:** article 73 second paragraph (part) of *CRD*]

2.2.14 R As part of its obligations under the *overall Pillar 2 rule*, a firm must :

(1) make an assessment of the *firm*-wide impact of the risks identified in line with that *rule*, to which end a *firm* must aggregate the risks across its various business lines and units, taking appropriate account of the correlation between risks;

(2) take into account the stress tests that the *firm* is required to carry out as follows:

(a) (for a *significant IFPRU firm*) under the *general stress and scenario testing rule* (including SYSC 20 (Reverse stress testing));

(b) (except a *firm* in (a)) under SYSC 20 (Reverse stress testing);

and any stress tests that the *firm* is required to carry out under the *EU CRR*;

(3) have processes and systems that:

(a) include an assessment of how the *firm* intends to deal with each of the major sources of risk identified in line with IFPRU 2.2.7 R (2); and

(b) take account of the impact of the diversification effects and how such effects are factored into the *firm*'s systems for measuring and managing risks.

2.2.15 G Certain risks, such as systems and controls weaknesses, may not be adequately addressed by, for example, holding additional capital and a more appropriate response would be to rectify the weakness. In such circumstances, the amount of financial resources required to address these risks might be zero. However, a *firm* should consider whether holding additional capital might be an appropriate response until the identified weaknesses are rectified. A *firm*, should, in line with IFPRU 2.2.43 R to IFPRU 2.2.44 R (Documentation of risk assessments), document the approaches taken to manage these risks.

2.2.16 G (1) A *firm* should:

(a) carry out assessments of the sort described in the *overall Pillar 2 rule* and IFPRU 2.2.13R on an ongoing basis; and

(b) document the assessments in (a), in line with IFPRU 2.2.43R to IFPRU 2.2.44R (Documentation of risk assessments), at least annually, or more frequently if changes in the business, strategy, nature or scale of its activities or operational environment suggest that the current level of financial resources is no longer adequate.

(2) The appropriateness of the internal process, and the degree of involvement of *senior management* in the process, will be taken into account by the *FCA* when reviewing a *firm's* assessment as part of the *FCA*'s own assessment of the adequacy of a *firm*'s financial resources and internal capital. The processes and systems should ensure that the assessment of the adequacy of a *firm*'s financial resources and internal capital is reported to its *senior management* as often as is necessary.

Credit and counterparty risk

2.2.17 R A *firm* must base credit-granting on sound and well-defined criteria and clearly establish the process for approving, amending, renewing and re-financing credits.

[**Note:** article 79(a) of *CRD*]

2.2.18 R A *firm* must have internal methodologies that:

(1) enable it to assess the credit risk of exposures to individual obligors, securities or *securitisation positions* and credit risk at the portfolio level;

(2) do not rely solely or mechanistically on external credit ratings;

(3) where its *own funds requirements* under Part Three of the *EU CRR* (Capital Requirements) are based on a rating by an *ECAI* or based on the fact that an exposure is unrated, enable the *firm* to consider other relevant information for assessing its allocation of financial resources and internal capital.

[**Note:** article 79(b) of *CRD*]

2.2.19 R A *firm* must operate through effective systems the ongoing administration and monitoring of its various credit risk-bearing portfolios and exposures, including for identifying and managing problem credits and for making adequate value adjustments and provisions.

[**Note:** article 79(c) of *CRD*]

2.2.20 R A *firm* must adequately diversify credit portfolios given its target markets and overall credit strategy.

[**Note:** article 79(d) of *CRD*]

Residual risk

2.2.21 R A *firm* must address and control, by means which include written policies and procedures, residual risk (see IFPRU 2.2.8 R (2) and IFPRU 2.3.41 G).

[**Note:** article 80 of *CRD*]

Concentration risk

2.2.22 R A *firm* must address and control, by means which include written policies and procedures, the concentration risk arising from:

(1) exposures to each counterparty, including central counterparties, groups of connected counterparties and counterparties in the same economic sector, geographic region or from the same activity or commodity;

(2) the application of *credit risk mitigation* techniques; and

(3) risks associated with large indirect credit exposures, such as a single collateral issuer.

[**Note:** article 81 of *CRD*]

2.2.23 R In IFPRU 2.2.22 R, the processes, strategies and systems relating to concentration risk must include those necessary to ensure compliance with Part Four of the *EU CRR* (Large exposures).

Securitisation risk

2.2.24 R A *firm* must evaluate and address through appropriate policies and procedures the risks arising from *securitisation* transactions in relation to which a *firm* is investor, *originator* or *sponsor*, including reputational risks, to ensure, in particular, that the economic substance of the transaction is fully reflected in risk assessment and management decisions.

[**Note:** article 82(1) of *CRD*]

2.2.25 R A *firm* which is an *originator* of a revolving *securitisation* transaction involving early amortisation provisions must have liquidity plans to address the implications of both scheduled and early amortisation.

[**Note:** article 82(2) of *CRD*]

Market risk

2.2.26 R A *firm* must implement policies and processes for the identification measurement and management of all material sources and effects of *market risks*.

[**Note:** article 83(1) of *CRD*]

2.2.27 R A *firm* must take measures against the risk of a shortage of liquidity if the short position falls due before the long position.

[**Note:** article 83(2) of *CRD*]

2.2.28 R

(1) A *firm*'s financial resources and internal capital must be adequate for material *market risk* that are not subject to an *own funds requirement* under Part Three of the *EU CRR* (Capital Requirements).

(2) A *firm* which has, in calculating *own funds requirements* for position risk in accordance with Part Three, Title IV, Chapter 2 of the *EU CRR* (Own funds requirements for position risk), netted off its positions in one or more of the equities constituting a stock-index against one or more positions in the stock index future or other stock-index product, must have adequate financial resources and internal capital to cover the basis risk of loss caused by the future's or other product's value not moving fully in line with that of its constituent equities. A *firm* must also have such adequate financial resources and internal capital where it holds opposite positions in stock-index futures which are not identical in respect of either their maturity or their composition or both.

(3) A *firm* using the treatment in article 345 of the *EU CRR* (Underwriting: Reduction of net positions) must ensure that it holds sufficient financial resources and internal capital against the risk of loss which exists between the time of the initial commitment and the following working day.

[**Note:** article 83(3) of *CRD*]

2.2.29 R As part of its obligations under the *overall Pillar 2 rule*, a *firm* must consider whether the value adjustments and provisions taken for *positions* and portfolios in the *trading book* enable the *firm* to sell or hedge out its *positions* within a short period without incurring material losses under normal market conditions.

[**Note:** article 98(4) of *CRD*]

Interest risk arising from non-trading book activities

2.2.30 R A *firm* must implement systems to identify, evaluate and manage the risk arising from potential changes in interest rates that affect a *firm*'s non-trading activities.

[**Note:** article 84 of *CRD*]

2.2.31 R

(1) As part of its obligations under the *overall Pillar 2 rule*, a *firm* must carry out an evaluation of its exposure to the interest-rate risk arising from its non-trading activities.

(2) The evaluation under (1) must cover the effect of a sudden and unexpected parallel change in interest rates of 200 basis points in both directions.

(3) A *firm* must immediately notify the *FCA* if any evaluation under this *rule* suggests that, as a result of the change in interest rates described in (2), the economic value of the *firm* would decline by more than 20% of its *own funds*.

(4) A *firm* must carry out the evaluation under (1) as frequently as necessary for it to be reasonably satisfied that it has at all times a sufficient understanding of the degree to which it is exposed to the risks referred to in (1) and the nature of that exposure. In any case it must carry out those evaluations no less frequently than once a year.

[**Note:** article 98(5) of *CRD*]

Operational risk

2.2.32 R A *firm* must implement policies and processes to evaluate and manage the exposure to operational risk, including model risk and to cover low-frequency high severity events. Without prejudice to the definition of *operational risk*, a *firm* must articulate what constitutes *operational risk* for the purposes of those policies and procedures.

[**Note:** article 85(1) of *CRD*]

2.2.33 R A *firm* must have adequate contingency and business continuity plans in place aimed at ensuring that, in the case of a severe business disruption, the *firm* is able to operate on an ongoing basis and that any losses are limited.

[**Note:** article 85(2) of *CRD*]

Risk of excessive leverage

2.2.34 R

(1) A *firm* must have policies and procedures in place for the identification, management and monitoring of the *risk of excessive leverage*.

(2) Those policies and procedures must include, as an indicator for the *risk of excessive leverage*, the leverage ratio determined in accordance with article 429 of the *EU CRR* (Calculation of the leverage ratio) and mismatches between assets and obligations.

[**Note:** article 87(1) of *CRD*]

2.2.35 R A *firm* must address the *risk of excessive leverage* in a precautionary manner by taking due account of potential increases in that risk caused by reductions of the *firm*'s *own funds* through expected or realised losses, depending on the applicable accounting rules. To that end, a *firm* must be able to withstand a range of different stress events with respect to the *risk of excessive leverage*.

[**Note:** article 87(2) of *CRD*]

General stress and scenario testing

2.2.36 R The *general stress and scenario testing rule* in IFPRU 2.2.37 R and related *rules* and *guidance* apply to a *significant IFPRU firm*.

2.2.37 R (1) As part of its obligation under the *overall Pillar 2 rule*, a *firm* that is a *significant IFPRU firm* must:

(a) for the major sources of risk identified in line with IFPRU 2.2.7R(2), carry out stress tests and scenario analyses that are appropriate to the nature, scale and complexity of those major sources of risk and to the nature, scale and complexity of the *firm*'s business; and

(b) carry out the reverse stress testing under SYSC 20 (Reverse stress testing).

(2) In carrying out the stress tests and scenario analyses in (1), a *firm* must identify an appropriate range of adverse circumstances of varying nature, severity and duration relevant to its business and risk profile and consider the exposure of the *firm* to those circumstances, including:

(a) circumstances and events occurring over a protracted period of time;

(b) sudden and severe events, such as market shocks or other similar events; and

(c) some combination of the circumstances and events described in (a) and (b), which may include a sudden and severe market event followed by an economic recession.

(3) In carrying out the stress tests and scenario analyses in (1), the *firm* must estimate the financial resources that it would need in order to continue to meet the *overall financial adequacy rule* and the *own funds requirements* under the obligations laid down in Part Three of the *EU CRR* (Capital requirements) in the adverse circumstances being considered.

(4) In carrying out the stress tests and scenario analyses in (1), the *firm* must assess how risks aggregate across business lines or units, any

material non-linear or contingent risks and how risk correlations may increase in stressed conditions.

(5) A *firm* must carry out the stress tests and scenario analyses at least annually, unless:

(a) it is notified by the *FCA* to carry out more frequent or ad-hoc stress tests and scenario analyses; or

(b) the nature, scale and complexity of the major sources of risk identified by it under the *overall Pillar 2 rule* make it appropriate to carry out more frequent stress tests and scenario analyses.

(6) A *firm* must report to the *FCA* the results of the stress tests and scenario analysis annually and not later than six *months* after its annual reporting date.

[**Note:** article 100 of *CRD*]

2.2.38 G To comply with the *general stress and scenario testing rule*, a *firm* should undertake a broad range of stress tests which reflect a variety of perspectives, including sensitivity analysis, scenario analysis and stress testing on an individual portfolio, as well as a *firm*-wide level.

2.2.39 G A *firm* with an IRB permission which has any material credit *exposures* excluded from its IRB models should also include these *exposures* in its stress and scenario testing to meet its obligations under the *general stress and scenario testing rule*. A *firm* without IRB permission should conduct analyses to assess risks to the credit quality of its counterparties, including any protection sellers, considering both on and off-balance sheet exposures.

2.2.40 G In carrying out the stress tests and scenario analyses under IFPRU 2.2.37 R (1), a *firm* should also consider any impact of the adverse circumstances on its *own funds*. In particular, a *firm* should consider the capital ratios in article 92 of the *EU CRR* (Own funds requirements) where its *common equity tier 1 capital* and *additional tier 1 capital* is eroded by the event.

2.2.41 G A *firm* should assign adequate resources, including IT systems, to stress testing and scenario analysis, taking into account the stress testing techniques used, in order to accommodate different and changing stress tests at an appropriate level of granularity.

2.2.42 G For the purpose of IFPRU 2.2.37 R (5), a *firm* should consider whether the nature of the major sources of risks identified by it, in line with IFPRU 2.2.7 R (2) (Main requirement relating to risk strategies, processes and systems), and their possible impact on its financial resources suggest that such tests and analyses should be carried out more frequently. For instance, a sudden change in the economic outlook may prompt a *firm* to revise the parameters of some of its stress tests and scenario analyses. Similarly, if a *firm* has recently become exposed to a particular sectoral concentration, it may wish to add some stress tests and scenario analyses to reflect that concentration.

Documentation of risk assessments

2.2.43 R A *firm* must make a written record of the assessments required under this chapter. These assessments include those carried out on a consolidated basis and on an individual basis. In particular, it must make a written record of:

(1) the major sources of risk identified in accordance with the *overall Pillar 2 rule*;

(2) how it intends to deal with those risks; and

(3) details of the stress tests and scenario analyses carried out, including any assumptions made in relation to scenario design and the resulting financial resources estimated to be required in accordance with the *general stress and scenario testing rule*.

2.2.44 R A *firm* must maintain the records in IFPRU 2.2.43 R for at least three years.

Level of application: ICAAP rules

2.2.45 R A *firm* must apply the *ICAAP rules* on an individual basis if it is not:

(1) a *subsidiary undertaking* of a *parent undertaking* incorporated in, or formed under the law of any part of, the *United Kingdom*; and

(2) a *parent undertaking*.

2.2.46 R A *firm* that is not a member of a *FCA* consolidation group must apply the *ICAAP rules* on an individual basis.

[**Note:** article 108(1) of *CRD*]

2.2.47 R A *firm* which is a *parent institution in a Member State* must comply with the *ICAAP rules* on a *consolidated basis*.

[**Note:** article 108(2) of *CRD*]

2.2.48 R A *firm* controlled by a *parent financial holding company in a Member State* or a *parent mixed financial holding company in a Member State* must comply with the *ICAAP rules* on the basis of the *consolidated situation* of that holding company, if the *FCA* is responsible for supervision of the *firm* on a *consolidated basis* under article 111 of *CRD*.

[**Note:** article 108(3) of *CRD*]

2.2.49 R A firm that is a subsidiary must apply the *ICAAP rules* on a *sub-consolidated basis* if the *firm*, or the *parent undertaking* where it is a *financial holding company* or *mixed financial holding company*, have an *institution* or *financial institution* or an asset management company as a *subsidiary* in a *third country* or hold a *participation* in such an undertaking as members of a *non-EEA sub-group*.

[**Note:** article 108(4) of *CRD*]

Extent and manner of prudential consolidation

2.2.50 R If the *ICAAP rules* apply to a *firm* on a *consolidated basis*, the *firm* must carry out consolidation to the extent and in the manner prescribed in Part One, Title II, Chapter 2, section 2 of the *EU CRR* (Methods for prudential consolidation) and IFPRU 8.1(Prudential consolidation).

2.2.51 R For the purpose of the *ICAAP rules* as they apply on a *consolidated basis* or on a *sub-consolidated basis*:

(1) the *firm* must ensure that the *FCA consolidation group* has the processes, strategies and systems required by the *overall Pillar 2 rule*;

(2) the risks to which the *overall Pillar 2 rule* and the *general stress and scenario testing rule* refer are those risks as they apply to each member of the *FCA consolidation group*;

(3) the reference in the *overall Pillar 2 rule* to amounts and types of financial resources, *own funds* and internal capital (referred to in this *rule* as resources) must be read as being to the amounts and types that the *firm* considers should be held by the members of the *FCA consolidation group*;

(4) other references to resources must be read as being to resources of the members of the *FCA consolidation group*;

(5) the reference in the *overall Pillar 2 rule* to the distribution of resources must be read as including a reference to the distribution between members of the *FCA consolidation group*; and

(6) the reference in the *overall Pillar 2 rule* to the *overall financial adequacy rule* must be read as being to that *rule* as adjusted under IFPRU 2.2.63 R (Application of the *overall financial adequacy rule* on a consolidated basis).

2.2.52 R (1) This *rule* relates to the assessment of the amounts, types and distribution of financial resources, *own funds* and internal capital (referred to in this *rule* as "resources") under the *overall Pillar 2 rule* as applied on a *consolidated basis* and to the assessment of diversification effects as referred to in IFPRU 2.2.14 R (3)(b) as applied on a *consolidated basis*.

(2) A *firm* must be able to explain how it has aggregated the risks referred to in the *overall Pillar 2 rule* and the financial resources, *own funds* and internal capital required by each member of the *FCA consolidation group* and how it has taken into account any diversification benefits for the group in question.

(3) In particular, to the extent that the transferability of resources affects the assessment in (2), a *significant IFPRU firm* must be able to explain how it is satisfied that resources are transferable between members of the group in question in the stressed cases and the scenarios referred to in the *general stress and scenario testing rule*.

2

2.2.53 R

(1) A *firm* must allocate the total amount of financial resources, *own funds* and internal capital identified as necessary under the *overall Pillar 2 rule* (as applied on a consolidated basis) between different parts of the *FCA consolidation group*. IFPRU 2.2.11 R (Identifying different tiers of capital) does not apply to this allocation

(2) The *firm* must carry out the allocation in (1) in a way that adequately reflects the nature, level and distribution of the risks to which the group is subject and the effect of any diversification benefits.

2.2.54 R

A *firm* must also allocate the total amount of financial resources, *own funds* and internal capital (referred to in this *rule* as "resources") identified as necessary under the *overall Pillar 2 rule* as applied on a *consolidated basis* or *sub-consolidated basis* between each *firm* which is a member of the *FCA consolidation group* on the following basis:

(1) the amount allocated to each *firm* must be decided on the basis of the principles in IFPRU 2.2.53 R (2); and

(2) if the process in (1) were carried out for each group member, the total so allocated would equal the total amount of resources identified as necessary under the *overall Pillar 2 rule*, as applied on a *consolidated basis* or *sub-consolidated basis*.

2.2.55 G

A *firm* to which the *ICAAP rules* apply on a *consolidated basis* need not prepare a *consolidated basis* assessment if such an assessment has been prepared by another member of its *FCA consolidation group*. In such cases, a *firm* may adopt such an assessment as its own. A *firm* nevertheless remains responsible for the assessment.

2.2.56 G

The purpose of IFPRU 2.2.52 R to IFPRU 2.2.55 G is to enable the *FCA* to assess the extent, if any, to which a *firm*'s assessment, calculated on a *consolidated basis*, is lower than it would be if each separate legal entity were to assess the amount of capital it would require to mitigate its risks (to the same level of confidence) were it not part of a group subject to consolidated supervision under Part One, Title II, Chapter 2 of the *EU CRR* (Prudential consolidation). The reason the *FCA* wishes to make this assessment is so that individual capital guidance which it gives is fair and comparable between different *firms* and groups. Group diversification benefits which a *firm* might assert exist can be a material consideration in a capital adequacy assessment. Understanding the methods used to aggregate the different risks (eg, the correlation assumptions) is crucial to a proper evaluation of such benefits.

2.2.57 G

Whereas a single legal entity can generally use its capital to absorb losses wherever they arise, there are often practical and legal restrictions on the ability of a group to do so. For instance:

(1) capital which is held by overseas regulated *firms* may not be capable of being remitted to a *firm* in the *UK* which has suffered a loss;

(2) a *firm* which is, or likely to become, insolvent may be obliged to look to the interests of its creditors first before transferring capital to other group *companies*; and

(3) a parent *company* may have to balance the interests of its shareholders against the protection of the creditors of a *subsidiary* which is, or might become, insolvent and may, rationally, conclude that a *subsidiary* should be allowed to fail rather than provide capital to support it.

Level of application: risk control rules

2.2.58 R The *risk control rules* apply to a *firm* on an individual basis whether or not they also apply to the firm on a *consolidated basis*.

[**Note:** article 109(1) of *CRD*]

2.2.59 R Where a *firm* is a member of a *FCA consolidation group* or a *non-EEA sub-group*, the *firm* must ensure that the risk management processes and internal control mechanisms at those levels comply with the obligations set out in the *risk control rules* on a *consolidated basis* (or a *sub-consolidated basis*).

[**Note:** article 109(2) of *CRD*]

2.2.60 R Compliance with the obligations in IFPRU 2.2.59 R must enable the *FCA consolidation group* or the *non-EEA sub-group* to have arrangements, processes and mechanisms that are consistent, well integrated and ensure that data relevant to the purpose of supervision can be produced.

[**Note:** article 109(2) of *CRD*]

Level of application: overall financial adequacy rule

2.2.61 R The *overall financial adequacy rule* applies to a *firm* on an individual basis, whether or not it also applies to the firm on a *consolidated basis* or *sub-consolidated basis*.

2.2.62 R The *overall financial adequacy rule* applies to a *firm* on a *consolidated basis* if the *ICAAP rules* apply to it on a *consolidated basis* and applies to a *firm* on a *sub-consolidated basis* if the *ICAAP rules* apply to it on a *sub-consolidated basis*.

2.2.63 R When the *overall financial adequacy rule* applies on a *consolidated basis* or *sub-consolidated basis*, the *firm* must ensure that at all times its *FCA consolidation group* maintains overall financial resources and internal capital, including *own funds* and liquidity resources, which are adequate, both as to amount and quality, to ensure that there is no significant risk that the liabilities of any members of its *FCA consolidation group* cannot be met as they fall due.

Additional guidance on stress tests and scenario analyses

2.2.64 G The *general stress and scenario testing rule* requires a *firm* to carry out stress tests and scenario analyses as part of its obligations under the *overall Pillar 2 rule*. Both stress tests and scenario analyses are undertaken by a *firm* to further a better understanding of the vulnerabilities that it faces under adverse conditions. They are based on the analysis of the impact of a range of events of varying nature, severity and duration. These events can be financial, operational or legal or relate to any other risk that might have an economic impact on the *firm*.

2.2.65 G Stress testing typically refers to shifting the values of individual parameters that affect the financial position of a *firm* and determining the effect on the *firm*'s financial position.

2.2.66 G Scenario analysis typically refers to a wider range of parameters being varied at the same time. Scenario analyses often examine the impact of adverse events on the *firm*'s financial position, for example, simultaneous movements in a number of risk categories affecting all of a *firm*'s business operations, such as business volumes, investment values and interest rate movements.

2.2.67 G There are three broad purposes of stress testing and scenario analysis:

(1) it can be used as a means of quantifying how much capital might be absorbed if an adverse event or events occurs (ie, a simple 'what if' approach to estimating exposure to risks), this might be a proportionate approach to risk management for an unsophisticated business;

(2) it can be used to provide a check on the outputs and accuracy of risk models, particularly in identifying non-linear effects when aggregating risks; and

(3) it can be used to explore the sensitivities in longer term business plans and how capital needs might change over time

2.2.68 G One of the main purposes of stress tests and scenario analyses under the *general stress and scenario testing rule* is to test the adequacy of overall financial resources. Scenarios need only be identified, and their impact assessed, in so far as this facilitates that purpose. In particular, the nature, depth and detail of the analysis depend, in part, upon the *firm*'s capital strength and the robustness of its risk prevention and risk mitigation measures.

2.2.69 G Both stress testing and scenario analyses are forward-looking analysis techniques which seek to anticipate possible losses that might occur if an identified risk crystallises. In applying them, a *firm* should decide how far forward to look. This should depend upon:

(1) how quickly it would be able to identify events or changes in circumstances that might lead to a risk crystallising resulting in a loss; and

(2) after it has identified the event or circumstance, how quickly and effectively it could act to prevent or mitigate any loss resulting from the risk crystallising and to reduce exposure to any further adverse event or change in circumstance.

2.2.70 G Where a *firm* is exposed to *market risk*, the time horizon over which stress tests and scenario analyses should be carried out will depend on, among other things, the maturity and liquidity of the *positions* stressed. For example, for the *market risk* arising from the holding of investments, this will depend upon:

(1) the extent to which there is a regular, open and transparent market in those assets, which would allow fluctuations in the value of the investment to be more readily and quickly identified; and

(2) the extent to which the market in those assets is sufficiently liquid (and would remain liquid in the changed circumstances contemplated in the stress test or scenario analysis) to allow the *firm*, if needed, to sell, hedge or otherwise mitigate the risks relating to its holding so as to prevent or reduce exposure to future price fluctuations. In devising stress tests and scenario analyses for *market risk*, a *firm* should also take into account the following:

(a) the *general stress and scenario testing rule* should include a regular programme of stress testing and scenario analysis of its trading book positions, both at the trading desk level and on a *firm*-wide basis, with the results of these tests being reviewed by *senior management* and reflected in the policies and limits the *firm* sets;

(b) the *firm's* stress testing programme should be comprehensive in both risk and *firm* coverage, and appropriate to the size and complexity of trading book positions held;

(c) for the purpose IFPRU 2.2.37 R (5)(b), the frequency of stress testing of trading book positions should be determined by the nature of the *positions*;

(d) the stress testing should include shocks which reflect the nature of the portfolio and the time it could take to hedge out or manage risks under severe market conditions;

(e) the *firm* should have procedures in place to assess and respond to the results of the stress testing programme, in particular, stress testing should be used to evaluate the *firm's* capacity to absorb losses or to identify steps to be taken by the *firm* to reduce risk;

(f) as part of its stress testing programme, the *firm* should consider how prudent valuation requirements in article 105 of the *EU CRR* will be met in a stressed scenario.

2.2.71 G In identifying scenarios and assessing their impact, a *firm* should take into account, where material, how changes in circumstances might impact upon:

(1) the nature, scale and mix of its future activities; and

(2) the behaviour of *counterparties*, and of the *firm* itself, including the exercise of choices (eg, options embedded in financial instruments or *contracts of insurance*).

2.2.72 G In determining whether it would have adequate financial resources in the event of each identified realistic adverse scenario, a *firm* should:

(1) only include financial resources that could reasonably be relied upon as being available in the circumstances of the identified scenario; and

(2) take account of any legal or other restriction on the use of financial resources.

Capital planning

2.2.73 G

(1) In identifying an appropriate range of adverse circumstances and events in accordance with IFPRU 2.2.37 R (2):

(a) a *firm* will need to consider the cycles it is most exposed to and whether these are general economic cycles or specific to particular markets, sectors or industries;

(b) for the purposes of IFPRU 2.2.37 R (2)(a), the amplitude and duration of the relevant cycle should include a severe downturn scenario based on forward-looking hypothetical events, calibrated against the most adverse movements in individual risk drivers experienced over a long historical period;

(c) the adverse scenarios considered should in general be acyclical and, accordingly, the scenario should not become more severe during a downturn and less severe during an upturn. However, the *FCA* does expect scenarios to be updated with relevant new economic data on a pragmatic basis to ensure that the scenario continues to be relevant; and

(d) the adverse scenarios considered should reflect a *firm*'s risk tolerance of the adverse conditions through which it expects to remain a going concern.

(2) In making the estimate required by IFPRU 2.2.37 R (3), a *firm* should project its *own funds* and required *own funds* over a time horizon of three to five years, taking account of its business plan and the impact of relevant adverse scenarios. In making the estimate, the *firm* should consider both the *own funds* required to meet its *own funds requirements* and the *own funds* needed to meet the *overall financial adequacy rule*. Those projections should be made in a manner consistent with its risk management processes and systems in IFPRU 2.2.7R.

(3) In projecting its financial position over the relevant time horizon, the *firm* should:

(a) reflect how its business plan would "flex" in response to the adverse events being considered, taking into account factors such as changing consumer demand and changes to new business assumptions;

(b) consider the potential impact on its stress testing of dynamic feedback effects and second order effects of the major sources of risk identified in accordance with IFPRU 2.2.7 R (2);

(c) estimate the effects on the *firm*'s financial position of the adverse event without adjusting for management actions;

(d) separately, identify any realistic management actions that the *firm* could, and would, take to mitigate the adverse effects of the stress scenario; and

(e) estimate the effects of the stress scenario on the *firm's* financial position after taking account of realistic management actions.

(4) A *firm* should identify any realistic management actions intended to maintain or restore its capital adequacy. These could include ceasing to transact new business after a suitable period, balance sheet shrinkage, restricting distribution of profits or raising additional capital. A *firm* should reflect management actions in its projections only where it could, and would, take such actions, taking account of factors such as market conditions in the stress scenario and its effects upon the *firm's* reputation with its counterparties and investors. The combined effect on capital and retained earnings should be estimated. To assess whether prospective management actions in a stress scenario would be realistic and to determine which actions the *firm* would and could take, the *firm* should take into account any pre-conditions that might affect the value of management actions as risk mitigants and analyse the difference between the estimates in (3)(c) and (3)(e) in sufficient detail to understand the implications of taking different management actions at different times, particularly where they represent a significant divergence from the *firm's* business plan.

(5) The *firm* should document its stress testing and scenario analysis policies and procedures, as well as the results of its tests in accordance with IFPRU 2.2.43 R to IFPRU 2.2.44 R (Documentation of risk assessments). These records should be included within the *firm's* *ICAAP* submission document.

(6) The *FCA* will review the *firm's* records in (5) as part of its *SREP*. The purpose of examining these is to enable the *FCA* to judge whether a *firm* will be able to continue to meet its *own funds requirements* and the *overall financial adequacy rule* throughout the projection period.

(7) If, after taking account of realistic management actions, a *firm's* stress-testing management plan shows that the *firm's* projected *own funds* are less than those required to continue to meet its *EU CRR* or needed to continue to meet the *overall financial adequacy rule* over the projection period, the *FCA* may require the *firm* to set out additional countervailing measures and off-setting actions to reduce such difference or to restore the *firm's* capital adequacy after the stress event.

(8) The *firm's* senior management or *governing body* should be actively involved and engaged in all relevant stages of the *firm's* stress testing and scenario analysis programme. This would include establishing an appropriate stress testing programme, reviewing the programme's implementation (including the design of scenarios) and challenging, approving and actioning the results of the stress tests.

2.2.74 G The *FCA* may formulate macroeconomic and financial market scenarios which a *firm* may use as an additional input to its *ICAAP* submission. In addition, the *FCA* may also ask a *firm* to apply specific scenarios directly in its *ICAAP* submission.

2.2.75 G A *firm* may consider scenarios in which expected future profits will provide capital reserves against future risks. However, it would only be appropriate to take into account profits that can be foreseen with a reasonable degree of certainty as arising before the risk against which they are being held could possibly arise. In estimating future reserves, a *firm* should deduct future dividend payment estimates or other forms of profits distribution from projections of future profits.

2.2.76 G

(1) Stress and scenario analyses should, in the first instance, be aligned with the risk appetite of the *firm*, as well as the nature, scale and complexity of its business and of the risks that it bears. The calibration of the stress and scenario analyses should be reconciled to a clear statement setting out the premise upon which the *firm's* internal capital assessment under the *overall Pillar 2 rule* is based.

(2) In identifying adverse circumstances and events in line with IFPRU 2.2.37 R (2), a *firm* should consider the results of any reverse stress testing conducted under SYSC 20. Reverse stress testing may be expected to provide useful information about the *firm's* vulnerabilities and variations around the most likely ruin scenarios for the purpose of meeting the *firm's* obligations under IFPRU 2.2.37 R. In addition, such comparison may help a *firm* to assess the sensitivity of its financial position to different stress calibrations.

2.2.77 G A *firm* should use the results of its stress testing and scenario analysis not only to assess capital needs, but also to decide if measures should be put in place to minimise the adverse effect on the *firm* if the risk covered by the stress or scenario test actually materialises. Such measures might be a contingency plan or might be more concrete risk mitigation steps.

Pension obligation risk

2.2.78 G This section contains guidance on the assessment required by IFPRU 2.2.7 R (2)(k) for a *firm* exposed to pension obligation risk as defined in IFPRU 2.2.8 R (5).

2.2.79 G The focus of the risk assessment is on the *firm's* funding obligations towards the pension scheme, not of the pension scheme's risks themselves (i.e. the scheme's segregated assets and liabilities). A *firm* should include in its estimate of financial resources both its expected obligations to the pension scheme and any increase in obligations that may arise in a stress scenario.

2.2.80 G If a *firm* has a current funding obligation in excess of normal contributions or there is a risk that such a funding obligation will arise then, when calculating available capital resources, the *firm* should include these sources of risk as part of its:

(1) stress tests and scenario analysis under IFPRU 2.2.37R and considering at least the scenarios in IFPRU 2.2.81G; and

(2) capital projections under IFPRU 2.2.73G.

2.2.81 G A *firm* may wish to consider the following scenarios:

(1) one in which the *firm* gets into difficulties with an effect on its ability to fund the pension scheme; and

(2) one in which the pension scheme position deteriorates (e.g. because either investment returns, or interest rate assumptions, or both, fall below expected returns or because of increases in life expectancy) with an effect on the *firm's* funding obligations; taking into account the management actions the *firm* could and would take.

2.2.82 G A *firm* is expected to determine where the scope of any stress test impacts upon its pension obligation risk and estimate how the relevant measure of pension obligation risk will change in that scenario. For example, in carrying out stress tests under IFPRU 2.2.37 R, a *firm* must consider how a stress scenario, such as an economic recession, would impact on the *firm's* current obligations towards its pension scheme and any potential increase in those obligations. Risks such as interest-rate risk or reduced investment returns may have a direct impact on a *firm's* financial position as well as an indirect impact resulting from an increase in the *firm's* pension scheme obligations. Both effects should be taken into account in a *firm's* estimate of financial resources under IFPRU 2.2.7 R (Overall Pillar 2 rule).

2.2.83 G A *firm* should consider issues such as:

(1) the extent to which trustees of the pension scheme or a pension regulator (such as the one created under the Pensions Act 2004) can compel a certain level of contributions or a one-off payment in adverse financial situations or to meet the minimum legal requirements under the scheme's trust deed and rules or applicable laws relating to the pension scheme;

(2) whether the valuation bases used to set pension scheme contribution rates are consistent with the *firm's* current business plans and anticipated changes in the workforce; and

(3) which valuation basis is appropriate, given the expected investment return on scheme assets and actions the *firm* can take if those returns do not materialise.

2.2.84 G A *firm* should carry out analyses only to a degree of sophistication and complexity which is commensurate with the materiality of its pension risks.

Group risk

2.2.85 G This section contains additional guidance on the assessment required by IFPRU 2.2.7 R (2)(l) (Group risk).

2.2.86 G A *firm* should include in the written record in IFPRU 2.2.43 R (Documentation of risk assessments) a description of the broad business strategy of the *FCA consolidation group* or the *non-EEA sub-group* of which it is a member, the group's view of its principal risks and its approach to measuring, managing and controlling the risks. This description should include the role of stress testing, scenario analysis and contingency planning in managing risk on an individual basis and *consolidated basis*.

2.2.87 G A *firm* should satisfy itself that the systems (including IT) of the *FCA consolidation group* or the *non-EEA sub-group* of which it is a member are sufficiently sound to support the effective management and, where applicable, the quantification of the risks that could affect the *FCA consolidation group* or the *non-EEA sub-group*, as the case may be.

2.2.88 G In performing stress tests and scenario analyses, a *firm* should take into account the risk that its *group* may have to bring back on to its consolidated balance sheet the assets and liabilities of off-balance sheet entities as a result of reputational contagion, notwithstanding the appearance of legal risk transfer.

2.2.89 G A *firm* should carry out stress tests and scenario analyses to a degree of sophistication which is commensurate with the complexity of its group and the nature of its *group* risk.

2.3 Supervisory review and evaluation process: internal capital adequacy standards

[**Note**: On 19 December 2014, the *EBA* published guidelines on common procedures and methodologies for the supervisory review and evaluation process. The *FCA* has confirmed its intention to make every effort to comply with these guidelines that can be found at: http://www.eba.europa.eu/documents/10180/935249/EBA-GL-2014-13+%28Guidelines+on+SREP+methodologies+and+processes%29.pdf/ .]

Purpose

2.3.1 G

(1) IFPRU 2.3 sets out guidance on IFPRU 2.2 (Adequacy of financial resources) so far as it applies to an *IFPRU investment firm*. In particular, *guidance* on how a *firm* should carry out its *ICAAP*, as well as some factors the *FCA* will take into consideration when undertaking a *SREP*. The terms *ICAAP* and *SREP* are explained in IFPRU 2.3.3 G. IFPRU 2.3.48 G to IFPRU 2.3.52 R are *rules* that apply to a *firm* with an IRB permission.

(2) IFPRU 2.3 is mainly written on the basis that IFPRU 2.2 (Adequacy of financial resources) applies to a *firm* on an individualbasis. However, it is still relevant when IFPRU 2.2 applies on a *consolidated basis*. When IFPRU 2.2 applies on a *consolidated basis*, IFPRU 2.3 should be read with appropriate adjustments.

2.3.1A G

BIPRU 12 contains *rules* and *guidance* relating to the adequacy of a *firm's* liquidity resources and its assessment by the *firm* and the *FCA*.

Meaning of capital

2.3.2 G

For the purpose of IFPRU 2.3, "capital" refers to a *firm*'s financial resources, *own funds* and internal capital, all as referred to in the *overall Pillar 2 rule*.

The ICAAP and the SREP: introduction

2.3.3 G

The adequacy of a *firm*'s capital needs to be assessed both by a *firm* and the *FCA*. This process involves:

(1) an *internal capital adequacy assessment process* (*ICAAP*), which a *firm* is obliged to carry out in accordance with the *ICAAP rules*; and

(2) a supervisory review and evaluation process (*SREP*), which is conducted by the *FCA*.

2

The ICAAP and the SREP: the ICAAP

2.3.4 G The obligation to conduct an *ICAAP* includes requirements on a *firm* to:

(1) carry out regularly assessments of the amounts, types and distribution of financial resources, *own funds* and internal capital that it considers adequate to cover the nature and level of the risks to which it is or might be exposed (IFPRU 2.2.1 R to IFPRU 2.2.6 G (the *overall Pillar 2 rule* and related *rules*));

(2) identify the major sources of risk to its ability to meet its liabilities as they fall due (the *overall Pillar 2 rule*);

(3) conduct stress and scenario tests (the *general stress and scenario testing rule*, – including SYSC 20 (Reverse stress testing) – if it is a *significant IFPRU firm*; or SYSC 20 (Reverse stress testing) if it is not a *significant IFPRU firm*) taking into account, for a *firm* with an IRB permission, the stress test required by the *EU CRR*;

(4) ensure that the processes, strategies and systems required by the *overall Pillar 2 rule* and used in its *ICAAP*, are both comprehensive and proportionate to the nature, scale and complexity of that *firm's* activities (IFPRU 2.2.12 R); and

(5) document its *ICAAP* (IFPRU 2.2.43 R to IFPRU 2.2.44 R (Documentation of risk assessments)).

2.3.5 G (1) Where a *firm* is a member of a group, it should base its *ICAAP* on the consolidated financial position of the group. The group assessment should include information on:

(a) diversification benefits and transferability of resources between members of the group;

(b) the contribution of each member within the group to its overall risk profile; and

(c) an apportionment of the capital required by the group as a whole to the *firm* (IFPRU 2.2.45R to IFPRU 2.2.57G (Application of IFPRU 2.2 on an individual and consolidated basis)).

(2) A *firm* may, instead of preparing the *ICAAP* itself, adopt as its *ICAAP* an assessment prepared by other group members.

2.3.6 G A *firm* should ensure that its *ICAAP* is:

(1) the responsibility of the *firm's governing body*;

(2) reported to the *firm's governing body*; and

(3) forms an integral part of the *firm's* management process and decision-making culture.

The ICAAP and the SREP: the SREP

2.3.7 G The *FCA* will review a *firm's ICAAP*, including the results of the *firm's* stress tests carried out under *IFPRU* and the *EU CRR*, as part of its *SREP*. Provided that the *FCA* is satisfied with the appropriateness of a *firm*'s capital assessment, the *FCA* will take into account that *firm*'s *ICAAP* and stress tests in its *SREP*. More material on stress tests for a *firm* with an IRB permission can be found in IFPRU 2.3.50 R to IFPRU 2.3.54 G.

2.3.8 G The *SREP* is a process under which the *FCA*:

(1) reviews the arrangements, strategies, processes and mechanisms implemented by a *firm* to comply with *IFPRU*, *SYSC* and with requirements imposed by or under the *EU CRR* and wider *regulatory system* and evaluates the risks to which the *firm* is, or might be, exposed;

(2) determines whether the arrangements, strategies, processes and mechanisms implemented by the *firm* and the capital held by the *firm* ensures a sound management and coverage of the risks in (1); and

(3) (if necessary) requires the *firm* to take the necessary actions or steps at an early stage to address any failure to meet the requirements in (1).

2.3.9 G As part of its *SREP*, the *FCA* may ask a *firm* to provide it with the results of that *firm*'s *ICAAP*, together with an explanation of the process used. Where appropriate, the *FCA* will ask for additional information on the *ICAAP*.

2.3.10 G As part of its *SREP*, the *FCA* will consider whether the amount and quality of capital which a *firm* should hold to meet its *own funds requirements* in the *EU CRR* is sufficient for that *firm* to comply with the *overall financial adequacy rule*.

2.3.11 G After completing a review as part of the *SREP*, the *FCA* 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*.

2.3.12 G

(1) As part of its *SREP*, the *FCA* will also consider whether a *firm* should hold a *capital planning buffer* and the amount and quality of such *capital planning buffer*.

(2) In making these assessments, the *FCA* 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* and SYSC 20 (Reverse stress testing), and the extent to which the *firm* has used any of the capital buffers that are required of it under the *CRD*, as applicable.

(3) 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

2.3.13 G After completing a review as part of the *SREP*, the *FCA* 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 *FCA* may set a *firm's capital planning buffer* either as an amount and quality of capital which it should hold now (ie, at the time of the *FCA* notification following the *firm's SREP*) or, in exceptional cases, as a forward-looking target that the *firm* should build up over time.

2.3.14 G Where the amount or quality of capital which the *FCA* 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 *FCA* usually expects to discuss any such difference with the *firm*. Where necessary, the *FCA* may consider the use of its powers under section 166 of the *Act* (Reports by skilled persons) to assist in such circumstances.

2.3.15 G If a *firm* considers that the individual capital guidance given to it is inappropriate to its circumstances it should, consistent with *Principle* 11 (Relations with regulators), inform the *FCA* that it disagrees with that *guidance*. The *FCA* may reissue the individual capital guidance if, after discussion with the *firm*, the *FCA* 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 *FCA*.

2.3.16 G If a *firm* disagrees with the *FCA'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 *FCA* of its disagreement. The *FCA* may reconsider its initial assessment if, after discussion with the *firm*, the *FCA* 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.

2.3.17 G The *FCA* will not give individual capital guidance to the effect that the amount of capital advised in that *guidance* is lower than the amount of capital which a *firm* should hold to meet its *own funds requirements*.

2.3.18 G If, after discussion, the *FCA* and a *firm* still do not agree on an adequate level of capital, the *FCA* may consider using its powers under section55L of the *Act* on its own initiative to require the *firm* to hold capital in line with the *FCA's* view of the capital necessary to comply with the *overall financial adequacy rule*. In deciding whether it should use its powers under section 55L,the *FCA* will take into account the amount and quality of the *capital planning buffer* which the *firm* should hold as referred to in ■ IFPRU 2.3.13 G and ■ IFPRU 2.3.14 G. ■ SUP 7 provides further information about the *FCA's* powers under section 55L.

The drafting of individual capital guidance and capital planning buffer

2.3.19 G If the *FCA* gives individual capital guidance to a *firm*, the *FCA* will state what amount and quality of capital the *FCA* 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 *own funds* of an amount which is at least equal to a specified percentage of that *firm's total risk exposure amount* plus one or more static add-ons for specific risks, in line with the *overall Pillar 2 rule*.

2.3.20 G Individual capital guidance may refer to two types of *own funds*:

(1) General capital. It refers to total *common equity tier 1 capital* and *additional tier 1 capital* after applying deductions and prudential filters under the *EU CRR*.

(2) Total capital. It refers to total *common equity tier 1 capital*, *additional tier 1 capital* and *tier 2 capital* after applying deductions and prudential filters under the *EU CRR*.

2.3.21 G Where the *FCA* notifies a *firm* that it should hold a *capital planning buffer*, the notification will state what amount and quality of capital the *FCA* considers is adequate for the *firm* to hold. This will normally be notified to the *firm*, together with its individual capital guidance and expressed as a separate amount of *own funds* that the *firm* should hold in excess of the amount of *own funds* indicated as its individual capital guidance.

2.3.22 G For the purposes of IFPRU 2.3.21 G, IFPRU 2.3.20 G applies as it applies to individual capital guidance. References in those provisions to individual capital guidance should be read as if they were references to *capital planning buffer*. In relation to IFPRU 2.2.62 R, where the *general stress and scenario testing rule* or SYSC 20 (Reverse stress testing), as part of the *ICAAP rules*, applies to a *firm* on a *consolidated basis*, the *FCA* 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

2.3.23 G A *firm* continuing to hold capital in accordance with its individual capital guidance and its ability to carry on doing so is a fundamental part of the *FCA's* supervision of that *firm*. Therefore, if a *firm's own funds* have fallen, or are expected to fall, below the level advised in individual capital guidance, then, consistent with *Principle* 11 (Relations with regulators), a *firm* should inform the *FCA* of this fact as soon as practicable, explaining why this has happened or is expected to happen and:

(1) what action the *firm* intends to take to increase its own funds or to reduce its risks and hence its own funds requirements; or

(2) what modification the *firm* considers should be made to the individual capital guidance which it has been given.

2.3.24 G In the circumstance in IFPRU 2.3.23 G, the *FCA* may ask a *firm* for alternative or more detailed proposals and plans or further assessments and analyses of capital adequacy and risks faced by the *firm*. The *FCA* will seek to agree with the firm appropriate timescales and scope for any such additional work, in the light of the circumstances which have arisen.

2.3.25 G If a *firm* has not accepted individual capital guidance given by the *FCA* it should, nevertheless, inform the *FCA* as soon as practicable if its *own funds* have fallen, or are expected to fall, below the level suggested by that individual capital guidance.

2.3.26 G Monitoring the use of a *firm's capital planning buffer* is also a fundamental part of the *FCA*'s supervision of that *firm*. A *firm* should only use its *capital planning buffer* to absorb losses or meet increased own funds 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.

2.3.27 G Consistent with *Principle* 11 (Relations with regulators), a *firm* should notify the *FCA* 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*.

2.3.28 G Following discussions with the *firm* on the items listed in ■ IFPRU 2.3.27 G, the *FCA* 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 ■ IFPRU 2.3.27 G (3). The *FCA* 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.

2.3.29 G Where a *firm's capital planning buffer* is being drawn down due to circumstances other than those in ■ IFPRU 2.3.26 G, such as poor planning or mismanagement, the *FCA* may ask the *firm* for more detailed plans for it to restore its *capital planning buffer*. In the light of the relevant circumstances, the *FCA* may consider taking other remedial actions, which may include using its powers under section 55L of the *Act* on its own initiative, to impose a *requirement* on a *firm*.

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

2.3.31 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 *FCA* and provide the information referred to in IFPRU 2.3.27 G as soon as practicable afterwards.

2.3.32 G IFPRU 2.3.23 G to IFPRU 2.3.31 G also apply to individual capital guidance and to *capital planning buffer* on a *consolidated basis*.

Proportionality of an ICAAP

2.3.33 G IFPRU 2.3.34 G to IFPRU 2.3.36G set out what the *FCA* considers to be a proportional approach to preparing an *ICAAP* as referred to in IFPRU 2.2.12 R (The processes, strategies and systems required by the *overall Pillar 2 rule* should be comprehensive and proportionate), according to the relative degree of complexity of a *firm's* activities. If a *firm* adopts the appropriate approach, it may enable the *FCA* more easily to review a *firm's* *ICAAP* when the *FCA* undertakes its *SREP*. The *FCA* is also likely to place more reliance on an *ICAAP* which takes the appropriate form described in IFPRU 2.3.34 G to IFPRU 2.3.36 G than would otherwise be the case, although there may also be circumstances in which the *FCA* will be able to rely on an *ICAAP* that is not drawn up in that form.

2.3.34 G

(1) This paragraph applies to a firm that is not a *significant IFPRU firm* (see IFPRU 1.2.3 R) whose activities are simple and primarily not credit-related.

(2) In carrying out its *ICAAP* it could:

(a) identify and consider that *firm's* largest losses over the last three to five years and whether those losses are likely to recur;

(b) prepare a short list of the most significant risks to which that *firm* is exposed;

(c) consider how that *firm* would act, and the amount of capital that would be absorbed, in the event that each of the risks identified were to materialise;

(d) consider how that *firm's* *own funds requirements* might alter under the scenarios in (c) and how its *own funds requirements* might alter in line with its business plans for the next three to five years;

(e) consider whether any of the risks in the *overall Pillar 2 rule* is applicable to the *firm* (it is unlikely that any of those risks not already identified in (a) or (b) will apply to a *firm* whose activities are simple);

(f) document the ranges of capital required in the scenarios identified and form an overall view on the amount and quality of capital which that *firm* should hold, ensuring that its senior management is involved in arriving at that view; and

(g) (to determine the amount of capital that would be absorbed in the circumstances in (c)) carry out simple sensitivity tests where the *firm* analyses the impact of a shift in the key risk parameters identified in (b) on the earnings of the *firm*.

(3) A *firm* is also expected to form a view on the consolidated amount of capital it should hold, as well as the capital required to be held for each of the individual risks identified under the *overall Pillar 2 rule*. For that purpose, it may conservatively sum the results of the individual tests performed in (2)(c). However, if the *firm* chooses to reduce that sum on the understanding that not all risks will materialise at the same time, then the *firm* should perform scenario tests that demonstrate that a reduction in capital is legitimate.

(4) A *firm* should conduct stress tests and scenario analyses in accordance with SYSC 20 (Reverse stress testing) to assess how that *firm*'s capital and *own funds requirements* would alter and what that *firm*'s reaction might be to a range of adverse scenarios, including operational and market events. Where relevant, a *firm* should also consider the impact of a severe economic or industry downturn on its future earnings, *own funds* and *own funds requirements*, taking into account its business plans. The downturn scenario should be based on forward-looking hypothetical events calibrated against the most adverse movements in individual risk drivers experienced over a long historical period.

2.3.35 G For a *firm* that is a *significant IFPRU firm* (see IFPRU 1.2.3 R) and whose activities are moderately complex, in carrying out its *ICAAP*, IFPRU 2.3.34 G (2) to IFPRU 2.3.34 G (4) apply. In addition, it could:

(1) having consulted the management in each major business line, prepare a comprehensive list of the major risks to which the business is exposed;

(2) estimate, with the aid of historical data, where available, the range and distribution of possible losses which might arise from each of those risks and consider using shock stress tests to provide risk estimates;

(3) consider the extent to which that *firm*'s *own funds requirements* adequately captures the risks identified in (1) and (2);

(4) for areas in which the *own funds requirements* is either inadequate or does not address a risk, estimate the additional capital (if any) needed to protect that *firm* and its *customers*, in addition to any other risk mitigation action that *firm* plans to take;

(5) consider the risk that that *firm*'s own analyses of capital adequacy may be inaccurate and that it may suffer from management weaknesses, which affect the effectiveness of its risk management and mitigation;

(6) project that *firm*'s business activities forward in detail for one year and in less detail for the next three to five years and estimate how that *firm*'s capital and *own funds requirements* would alter, assuming that business develops as expected;

(7) assume that business does not develop as expected and consider how that *firm*'s capital and *own funds requirements* would alter and what that *firm*'s reaction to a range of adverse economic scenarios might be (see IFPRU 2.2.7 R to IFPRU 2.2.44 R (the *overall Pillar 2 rule* and related *rules* and *guidance*)). Where appropriate, the adverse

scenarios should consider the impact of market events that are instantaneous or occur over an extended period of time but which are nevertheless still co-dependent on movements in economic conditions;

(8) document the results obtained from the analyses in (2), (4), (6) and (7) in a detailed report for that *firm*'s *senior management* and, where relevant, its *governing body*; and

(9) ensure that systems and processes are in place to review against performance the accuracy of the estimates made in (2), (4), (6) and (7).

2.3.36 G

(1) This paragraph applies to a proportional *ICAAP* in the case of a *firm* that is a *significant IFPRU firm* (see IFPRU 1.2.3 R) whose activities are complex.

(2) A proportional approach to that *firm*'s *ICAAP* should cover the matters identified in IFPRU 2.3.34 G and IFPRU 2.3.35 G, but is likely also to involve the use of models, most of which will be integrated into its day-to-day management and operation.

(3) Models of the kind referred to in (2) may be linked to generate an overall estimate of the amount of capital that a *firm* considers appropriate to hold for its business needs. For example, a *firm* is likely to use value-at-risk models for market risk (see Part Three, Title IV, Chapter 5 of the *EU CRR* (Use of internal models to calculate own funds requirements for market risk)), advanced modelling approaches for credit risk (see Part Three, Title II, Chapter 3 of the *EU CRR* (Internal Ratings Based Approach)) and, possibly, advanced measurement approaches for *operational risk* (see Part Three, Title III, Chapter 4 of the *EU CRR* (Advanced measurement approaches)). A *firm* might also use economic scenario generators to model stochastically its business forecasts and risks. A *firm* may also link such models to generate information on the economic capital desirable for that *firm*. A model which a *firm* uses to generate its target amount of economic capital is known as an economic capital model (ECM). Economic capital is the target amount of capital which maximises the return for a *firm*'s stakeholders for a desired level of risk.

(4) A *firm* is also likely to be part of a *group* and to be operating internationally. There is likely to be centralised control over the models used throughout the *group*, the assumptions made and their overall calibration.

(5) The more a *firm* integrates into its business such economic capital modelling, the more it is likely to focus on managing risks for the benefit of its stakeholders. Consequently, ECMs may produce capital estimates that differ from the amount of capital needed for regulatory purposes. For the *FCA* to rely on the results of a *firm*'s models, including ECMs, a *firm* should be able to explain the basis and results of its models and how the amount of capital produced reflects the amount of capital needed for regulatory purposes. Where they are not equal, the *FCA* will expect a *firm* to explain any differences. However, it may prove difficult to reconcile the outcome of a *firm*'s modelling with the *FCA*'s own assessment of the adequacy of that *firm*'s capital. For example, when matters of judgment are

2

involved in arriving at a *firm's* capital assessment or the *FCA* relies on information which cannot be fully disclosed to the *firm* (eg, comparisons with the *firm's* peers). Nevertheless, a *firm* whose ECM produces a different amount of capital to that required for regulatory purposes is still obliged to comply with the *overall Pillar 2 rule*. A *firm* should, therefore, be able to explain to the *FCA* how the outcome of its ECM is adjusted so that it complies with the *overall financial adequacy rule* and the *overall Pillar 2 rule*.

(6) Stress testing carried out under the *general stress and scenario testing rule* should provide senior management with a consolidated view of the amount of risk the *firm* is, or might be, exposed to under the chosen stress events. Senior management should be presented with information that considers the possibility of the risks materialising simultaneously in various proportions. For instance, it would be misrepresentative to simulate *market risk* stressed events without considering that, in those circumstances, market *counterparties* may be more likely to default. Accordingly, a *firm* could:

(a) carry out combined stress tests where assets and liabilities are individually subjected to simultaneous changes in two or more risk drivers; for instance, the change in value of each loan made by a *firm* may be estimated using simultaneous changes to both interest rates and stock market or property values;

(b) integrate the results of market and credit risk models, rather than aggregating the results of each model separately; and

(c) consider scenarios which include systemic effects on the *firm* of wider failures in the *firm's* market or systems upon which the *firm* depends and also any possible systemic effects caused by the *firm* itself suffering losses which affect other market participants which, in turn, exacerbate the *firm's* position.

(7) Furthermore, if a complex *firm* uses an ECM it should validate the assumptions of the model through a comprehensive stress testing programme. In particular, this validation should:

(a) test correlation assumptions (where risks are aggregated in this way) using combined stresses and scenario analyses;

(b) use stress tests to identify the extent to which the *firm's* risk models omit non-linear effects, for instance the behaviour of derivatives in market risk models; and

(c) consider not just the effect of parallel shifts in interest-rate curves, but also the effect of curves becoming steeper or flatter.

Guidance on risks to be covered in an ICAAP

2.3.37 G ■ IFPRU 2.3.37 G to ■ IFPRU 2.3.47 G set out *guidance* on some of the sources of risk identified in the *overall Pillar 2 rule*.■ IFPRU 2.3.50 R to ■ IFPRU 2.3.54 G contain material relating to a *firm* with an IRB permission.

2.3.38 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 *FCA*, between capital it holds to comply with the *overall financial adequacy rule*, capital it holds as a *capital planning buffer* and capital held for other purposes.

(2) The calibration of the *own funds requirements* assumes that a *firm*'s business is well diversified, well managed with assets matching its liabilities and good controls, and stable with no large, unusual or high risk transactions. A *firm* may find it helpful to assess the extent to which its business in fact differs from these assumptions and, therefore, what adjustments it might be reasonable for it to make to the *own funds requirements* to arrive at an adequate level of *own funds*.

Interest-rate risk arising from non-trading book activities

2.3.39 G A *firm* should assess its exposure to changes in interest rates, particularly risks arising from the effect of interest-rate changes on non-*trading book* activities that are not captured by the *own funds requirements*. In doing so, a *firm* may wish to use stress tests to determine the impact on its balance sheet of a change in market conditions.

Securitisation risk

2.3.40 G A *firm* should assess its exposure to risks transferred through the *securitisation* of assets should those transfers fail for whatever reason. A *firm* should consider the effect on its financial position of a *securitisation* arrangement failing to operate as anticipated or of the values and risks transferred not emerging as expected.

Residual risk

2.3.41 G A *firm* should assess its exposure to residual risks that may result from the partial performance or failure of *credit risk mitigation* techniques for reasons that are unconnected with their intrinsic value. This could result from, for instance, ineffective documentation, a delay in payment or the inability to realise payment from a guarantor in a timely manner. Given that residual risks can always be present, a *firm* should assess the appropriateness of its *own funds requirements* against its assumptions which underlie any risk mitigation measures it may have in place.

Concentration risk

2.3.42 G A *firm* should assess and monitor, in detail, its exposure to sectoral, geographic, liability and asset concentrations. The *FCA* considers that concentrations in these areas increase a *firm's* exposure to credit risk. Where a *firm* identifies such concentrations it should consider the adequacy of its *own funds requirements*.

Liquidity risk

2.3.43 G Under the *overall Pillar 2 rule*, a *firm* should consider its exposure to *liquidity risk* and assess its response should that risk materialise.

2.3.44 G When assessing *liquidity risk*, a *firm* should consider the extent to which there is a mismatch between assets and liabilities.

2.3.45 G A *firm* should also, when assessing *liquidity risk*, consider the amount of assets it holds in highly liquid, marketable forms that are available should unexpected cash flows lead to a liquidity problem. The price concession of liquidating assets is of prime concern when assessing such liquidity risk and should, therefore, be built into a *firm's ICAAP*.

2.3.46 G Some further areas to consider in developing the *liquidity risk* scenario might include:

(1) any mismatching between expected asset and liability cash flows;

(2) the inability to sell assets quickly;

(3) the extent to which a *firm's* assets have been pledged; and

(4) the possible need to reduce large asset positions at different levels of market liquidity and the related potential costs and timing constraints.

Business risk: general

2.3.47 G A *firm's own funds requirements*, being risk-sensitive, may vary as business cycles and economic conditions fluctuate over time. Deterioration in business or economic conditions could require a *firm* to raise capital or, alternatively, to contract its businesses at a time when market conditions are most unfavourable to raising capital. Such an effect is known as procyclicality.

2.3.48 G To reduce the impact of cyclical effects, a *firm* should aim to maintain an adequate *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.

2.3.49 G To assess its expected capital requirements over the economic and business cycles, a *firm* may wish to project forward its financial position taking account of its business strategy and expected growth, according to a range of assumptions regarding the economic or business environment which it faces. For example, an *ICAAP* should include an analysis of the impact that the actions of a *firm's* competitors might have on its performance, in order to see what changes in its environment the *firm* could sustain. Projections over a three- to five-year period would be appropriate in most circumstances. A *firm* may then calculate its projected *own funds requirements* and assess whether it could be met from expected financial resources. Additional *guidance* on capital planning over an economic and business cycle can be found in IFPRU 2.2.73 G (Capital planning).

Business risk: stress tests for firms using the IRB approach

2.3.50 R A *firm* with an IRB permission must ensure that there is no significant risk of it being unable to meet its own funds requirements for credit risk under Part Three, Title II of the *EU CRR* (Capital requirements for credit risk) at all times throughout an economic cycle, including the *own funds requirements* for credit risk indicated by any stress test carried out under article 177 of the *EU CRR* (Stress tests used in assessment of capital adequacy for a *firm* with an IRB permission) as being likely to apply in the scenario tested. To decide what *own funds* are, or will be, available to meet those credit risk requirements, a *firm* must exclude *own funds* that are likely to be required to meet its other capital requirements under the *EU CRR* at the relevant time. A *firm* must also be able to demonstrate to the *FCA*, at any time, that it is complying with this *rule*.

2.3.51 R IFPRU 2.3.50 R applies to a *firm* on an individual basis if Part Three, Title II, Chapter 3 of the *EU CRR* (IRB approach) applies to it on an individual basis and applies on a *consolidated basis* if the *EU CRR* does.

2.3.52 R If IFPRU 2.3.50 Rapplies to a *firm* on a *consolidated basis*, the following adjustments are made to IFPRU 2.3.50 R in accordance with the general principles of Part One, Title II, Chapter 2 of the *EU CRR* (Prudential consolidation):

(1) references to *own funds* are to the consolidated *own funds* of the *firm*'s *FCA consolidation group* or, as the case may be, its *non-EEA sub-group*; and

(2) references to the capital requirements in Part Three of the *EU CRR* (Capital requirements) are to the consolidated capital requirements with respect to the *firm's FCA consolidation group* or, as the case may be, its *non-EEA sub-group* under Part One, Title II, Chapter 2 of the *EU CRR* (Prudential consolidation).

2.3.53 G If a *firm*'s current available *own funds* are less than the own funds requirements indicated by the stress test, that does not necessarily mean there is a breach of IFPRU 2.3.50 R. The *firm* may wish to set out any countervailing effects and off-setting actions that can be demonstrated to the satisfaction of the *FCA* as being likely to reduce that difference. The *FCA* is only likely to consider a demonstration of such actions as credible if those actions are set out in a capital management plan based on the procedures in IFPRU 2.2.73 G (Capital planning) and include a plan of the type referred to in IFPRU 2.2.73 G (7) that has been approved by the *firm's senior management* or *governing body*.

2.3.54 G The countervailing factors and off-setting actions that a *firm* may rely on as referred to in IFPRU 2.3.53 G include, but are not limited to, projected balance sheet shrinkage, growth in *own funds* resulting from retained profits between the date of the stress test and the projected start of the economic downturn, the possibility of raising new capital in a downturn, the ability to reduce dividend payments or other distributions, and the ability to allocate capital from other risks which can be shown to be negatively correlated with the *firm's* credit risk profile.

2

Systems and controls

2.3.55 G A *firm* may decide to hold additional capital to mitigate any weaknesses in its overall control environment. These weaknesses might be indicated by the following:

(1) a failure by a *firm* to complete an assessment of its systems and controls to establish whether they comply with *SYSC*; or

(2) a failure by a *firm's senior management* to approve its financial results; or

(3) a failure by a *firm* to consider an analysis of relevant internal and external information on its business and control environment.

2.3.56 G In considering if there are any systems and control weaknesses, and their effect on the adequacy of the *own funds requirements*, a *firm* should be able to demonstrate to the *FCA* that all the issues identified in *SYSC* have been considered and that appropriate plans and procedures exist to deal adequately with adverse scenarios.

Risks which may be considered according to the nature of the activities of a firm

2.3.57 G (1) IFPRU 2.3.58 G to IFPRU 2.3.67 G set out *guidance* for:

(a) an asset management *firm*; and

(b) a securities *firm*;

(2) IFPRU 2.3.58 G to IFPRU 2.3.67 G provide examples of the sorts of risks which such a *firm* might typically face and of stress tests or scenario analyses which it might carry out as part of its *ICAAP*.

(3) The material on securities *firms* is also relevant to a commodities firm.

An asset management firm

2.3.58 G An asset manager is primarily exposed to *operational risk* and reputational risk.

2.3.59 G When assessing reputational risk, an asset manager should consider issues such as:

(1) how poor performance can affect its ability to generate profits;

(2) the effect on its financial position should one or more of its key fund managers leave that *firm*;

(3) the effect on its financial position should it lose some of its largest customers; and

(4) how poor customer services can affect its financial position; for example, a *firm* which has outsourced the management of customer accounts may want to consider the impact on its own reputation of the service provider failing to deliver the service.

2.3.60 G As an asset manager's mandates become more complex, the risk of it failing to comply fully with the terms of its contracts increases. In the event of such failure, a *firm* can be exposed to substantial losses resulting from customers' claims and legal actions. Although the *FCA* would expect an asset manager to have adequate controls in place to mitigate that risk, it may also like to consider the potential cost to it if customers claim that it has not adhered to mandates. Past claims and compensation may provide a useful benchmark for an asset manager to assess its sensitivity to future legal action. In assessing the adequacy of its capital, an asset manager may, therefore, consider whether it could absorb the highest operational loss it has suffered over the last three to five years.

2.3.61 G In relation to the issues identified in IFPRU 2.3.60 G, an asset manager should consider, for example:

(1) the direct cost to it resulting from fraud or theft;

(2) the direct cost arising from customers' claims and legal action in the future ? an asset manager could consider the impact on its financial position if a legal precedent were to encourage its customers to take legal action against it for failing to advise correctly on a certain type of product, the relevance of which is likely to depend on whether the asset manager is acting on a discretionary basis or solely as advisor; and

(3) where it has obtained professional indemnity insurance, the deductibles and individual or aggregate limits on the sums insured.

2.3.62 G The *FCA* expects an asset manager to consider the impact of economic factors on its ability to meet its liabilities as they fall due. Therefore, an asset manager should develop scenarios which relate to its strategic and business plan. An asset manager might consider:

(1) the effect of a market downturn that affects both transaction volumes and the market values of assets in its funds - in assessing the impact of such a scenario, an asset manager may consider the extent to which it can remain profitable (eg, by rapidly scaling down its activities and reducing its costs);

(2) the impact on current levels of capital if it plans to undertake a significant restructuring; and

(3) the impact on current levels of capital if it plans to enter a new market or launch a new product ? it should assess the amount of capital it needs to hold when operating for the first time in a market in which it lacks expertise.

A securities firm

2.3.63 G (1) A securities *firm* may consider the impact of the following situations on its capital levels when assessing its exposure to concentration risk:

(a) the potential loss that could arise from large exposures to a single *counterparty*;

(b) the potential loss that could arise from exposures to large transactions or to a product type; and

(c) the potential loss resulting from a combination of events such as a sudden increase in volatility leaving a hitherto fully-margined client unable to meet the margin calls due to the large size of the underlying *position* and the subsequent difficulties involved in liquidating its *position*.

(2) An example of (1)(b) relates to a securities *firm* which relies on the income generated by a large, one-off corporate finance transaction. It may want to consider the possibility of legal action arising from that transaction which prevents the payment of its fees. Additionally, an underwriting *firm* may, as a matter of routine, commit to place a large amount of securities. Therefore, it may like to assess the impact of losses arising from a failure to place the securities successfully.

2.3.64 G Where a securities *firm* deals in illiquid securities (eg, unlisted securities or securities listed on illiquid markets) or holds illiquid assets, potentially large losses can arise from trades that have failed to settle or because of large unrealised market losses. Therefore, a securities *firm* may consider the impact of *liquidity risk* on its exposure to:

(1) credit risk; and

(2) market risk.

2.3.65 G Counterparty risk requirements only partially capture the risk of settlement failure, as the quantification of risk is only based on mark-to-market values and does not take account of the volatility of the securities over the settlement period. A securities *firm's* assessment of its exposure to counterparty risk should take into account:

(1) whether it acts as arranger only or whether it also executes trades;

(2) the types of execution venues which it uses - for example, the London Stock Exchange or a retail service provider (RSP) have more depth than *multilateral trading facilities*; and

(3) whether it offers extended settlements and free delivery compared to delivery versus payment business.

2.3.66 G A securities *firm* should also consider the impact of external factors on the levels of capital it needs to hold. Scenarios covering such external factors should relate to its strategy and business plan. A securities *firm* might wish to consider the following factors:

(1) whether it plans to participate in a one-off transaction that might strain temporarily or permanently its capital;

(2) whether the unevenness of its revenue suggests that it should hold a capital buffer. Such an assessment could be based, for instance, on an analysis of past revenue and the volatility of its capital;

(3) how its income might alter as interest rates fluctuate where it is obliged to pay interest to its clients in excess of interest it earns on client money deposits;

(4) how its capital would be affected by a market downturn. For instance, how sensitive that *firm* is to a sharp reduction of trading volumes;

(5) how political and economic factors will affect that *firm*'s business. For instance, a commodity firm may wish to consider the impact of a sharp increase in prices on initial margins and, consequently, on its liquidity;

(6) whether it anticipates expanding its activities (eg, by offering clearing services) and, if so, the impact on its capital.

2.3.67 G A securities *firm* may also want to assess the impact of its internal credit limits on its levels of capital. For instance, a *firm* whose internal procedures authorise dealing without cash in the account, or without pre-set dealing limits, might consider more capital is required than if it operated stricter internal credit limits.

Capital models

2.3.68 G A *firm* may approach its assessment of adequate capital by developing a model, including an ECM (see IFPRU 2.3.36 G), for some or all of its business risks. The assumptions required to aggregate risks modelled and the confidence levels adopted should be considered by a *firm*'s *senior management*. A *firm* should also consider whether any relevant risks, including systems and control risks, are not captured by the model.

2.3.69 G A *firm* should not expect the *FCA* 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 *FCA* 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*.

2.3.70 G There is no prescribed approach as to how a *firm* should develop its internal capital model. However, a *firm* should be able to demonstrate:

(1) the confidence levels set and whether these are linked to its corporate strategy;

(2) the time horizons set for the different types of business that it undertakes;

(3) the extent of historic data used and back-testing carried out;

(4) that it has a process to verify the correctness of the model's outputs; and

(5) that it has the skills and resources to operate, maintain and develop the model.

2.3.71 G In relation to the use of an ECM (see IFPRU 2.3.36 G), the *FCA* is likely to place more reliance on a *firm's ICAAP* if the *firm* provides the following information:

(1) a comparison of the amount of capital that the ECM generates in respect of each of the risks captured in the *own funds requirements* before aggregation with the corresponding components of the *own funds requirements* calculation; and

(2) evidence that the *guidance* in IFPRU 2.3.68 G to IFPRU 2.3.75 G has been followed.

2.3.72 G If a *firm* adopts a top-down approach to developing its internal model, it should be able to allocate the outcome of the internal model to risks it has previously identified in relation to each separate legal entity, business unit or business activity, as appropriate. For a *firm* which is a member of a group, IFPRU 2.2.54 R (Application of IFPRU 2.2 on an individual basis and consolidated basis) sets out how internal capital identified as necessary by that *firm's ICAAP* should be allocated.

2.3.73 G If a *firm's* internal model makes explicit or implicit assumptions in relation to correlations within or between risk types, or diversification benefits between business types, the *firm* should be able to explain to the *FCA*, with the support of empirical evidence, the basis of those assumptions.

2.3.74 G A *firm's* model should also reflect the past experience of both the *firm* and the sectors in which it operates.

2.3.75 G The values assigned to inputs into a *firm's* model should be derived either stochastically, by assuming the value of an item can follow an appropriate probability distribution and by selecting appropriate values at the tail of the distribution, or deterministically, using appropriate prudent assumptions. For options or guarantees which change in value significantly in certain economic or demographic circumstances, a stochastic approach would normally be appropriate.

2.4 Reporting of breaches

2.4.1 R

(1) A *firm* must have appropriate procedures in place for its employees to report breaches internally through a specific, independent and autonomous channel.

(2) The channel in (1) may be provided through arrangements provided for by social partners, subject to the Public Interest Disclosure Act 1998 and the Employment Rights Act 1996 to the extent that they apply.

[**Note:** article 71(3) of *CRD*]

2.4.2 G

SYSC 18 (Whistleblowing) contains requirements on *UK SMCR banking firms* and certain *insurers* (see SYSC 18.1.1AR) in relation to the adoption and communication of appropriate internal procedures for handling *reportable concerns* as part of an effective risk management system. SYSC 18.1.1CG provides that *firms* not otherwise subject to SYSC 18 may nonetheless wish to adopt the provisions in that chapter as best practice.

2

2.5 Recovery and resolution plans

2.5.1 R [deleted]

2.5.2 R [deleted]

Chapter 3

Own funds

3

3.1 Base own funds requirement

Application

3.1.1 R This section applies to an *IFPRU investment firm*, unless it is an *exempt IFPRU commodities firm*.

3.1.2 R This section applies to a *firm* in relation to the whole of its business, except where a particular provision provides for a narrower scope.

3.1.3 G The adequacy of a *firm's own funds* needs to be assessed in relation to all the activities of the *firm* and risks to which they give rise.

Purpose

3.1.4 G This section implements EC standards for the *base own funds requirement* to be held by an *IFPRU investment firm*. In particular, it implements articles 28 and 29 of *CRD*.

3.1.5 G Principle 4 requires a *firm* to maintain adequate financial resources. IFPRU 3 sets out provisions that deal specifically with the adequacy of that part of a *firm's* financial resources that consists of *own funds* in addition to Parts Two (Own Funds) and Three (Capital requirements) of the *EU CRR*.

Main requirement

3.1.6 R

(1) Subject to (2), an *IFPRU investment firm* must maintain, at all times, *common equity tier 1 capital* equal to, or in excess of, the *base own funds requirement*.

(2) For the purpose of (1), the *common equity tier 1 capital* of an *IFPRU investment firm* must comprise only of one or more of the items referred to in article 26(1)(a) to (e) of the *EU CRR* (Common equity tier 1 items).

[**Note**: article 28(1) of *CRD*]

3.1.7 R At the time that it first becomes an *IFPRU investment firm*, a *firm* must hold *initial capital* of not less than the *base own funds requirement* applicable to that *firm*.

Calculation of the base own funds requirement

3.1.8 R The amount of an *IFPRU investment firm's base own funds requirement* is set out in the table in IFPRU 3.1.9 R.

Table: Base own funds requirement

3.1.9 R This table belongs to IFPRU 3.1.8 R.

Firm Category	Amount: Currency equivalent of
IFPRU 730K firm	€730,000
IFPRU 125K firm	€125,000
IFPRU 50K firm	€50,000

[**Note**: articles 28(2), 29(1) and 29(3) of *CRD*]

3.1.10 G A *collective portfolio management investment firm* is required to maintain *base own funds requirement* of €125,000 (in line with IPRU(INV) 11.3.1R(1)).

3

3.2 Capital

Application

3.2.1 R IFPRU 3 applies to an *IFPRU investment firm*, unless it is an exempt IFPRU commodities firm.

Purpose

3.2.2 G This chapter:

(1) contains the *rules* that exercise the discretion afforded to the *FCA* as *competent authority* under article 89 of the *EU CRR*;

(2) contains the *guidance* in relation to articles 4(1)(126) and 28 of the *EU CRR*; and

(3) contains the *rules* on notification to the *FCA* of intended issuance, or amendment to, *own funds* instruments and specified terms that meet the conditions for qualification as *own funds*.

Qualifying holding outside the financial sector

3.2.3 R In respect of the qualifying holdings described in article 89(1) and (2) of the *EU CRR*, a *firm* must, in accordance with article 89(3) of the *EU CRR*, comply with the requirement in article 89(3)(a) of the *EU CRR*.

Indirect or synthetic holdings

3.2.4 G For the purposes of article 4(1)(126) (Definition of synthetic holding) and Part Two (Own funds) of the *EU CRR*, the *FCA* considers the holdings described in IFPRU 3.2.5 G to be examples of indirect or synthetic holdings by an *IFPRU investment firm* of own common equity tier 1 instruments.

3.2.5 G An indirect or synthetic holding includes a holding of a *firm* of *shares*, any other interest in the capital and subordinated debt, whether in the *trading book* or non-*trading book*, in:

(1) an *institution* ; or

(2) a *financial institution*;

that satisfies the following conditions:

(3) the holding is the subject of an agreement or arrangement between the *firm* and either the issuer of the instrument in question or a member of the *group* to which the issuer belongs;

(4) under the terms of the agreement or arrangement described in (3), the issuer invests in the *firm* or in a member of the *group* to which the *firm* belongs;

(5) the effect of that agreement or arrangement on the capital position of the *firm*, the issuer or any member of a *group* to which either belongs, under any relevant rule is significantly more beneficial than in economic terms, taking into account the agreement or arrangement as a whole.

For this purpose, a relevant rule means a *rule* in *GENPRU*, *BIPRU*, *INSPRU* or *IFPRU* or any other capital adequacy or solvency requirements of the *FCA* or any other regulator, territory or country.

Connected transactions

3.2.6 R In determining whether an item of capital qualifies as *common equity tier 1 capital*, *additional tier 1 capital* or *tier 2 capital*, a *firm* must take into account any connected transaction which, when taken together with the item of capital, would cause it not to display the characteristics of *common equity tier 1 capital*, *additional tier 1 capital* or *tier 2 capital*.

3.2.7 R A *firm* must report to the *FCA* all connected transactions described in IFPRU 3.2.6 R at least one *month* in advance of entry into the relevant transaction and identify each relevant transaction with sufficient detail to allow the *FCA* to evaluate it.

Own funds instruments issued under third country law

3.2.8 R A *firm* must demonstrate to the *FCA* that any *additional tier 1 instrument* or tier 2 instrument issued by it that is governed by the law of a *third country* is by its terms capable, as part of a resolution of the *firm*, of being written down or converted into a common equity tier 1 instrument of the *firm* to the same extent as an equivalent *own funds* instrument issued under the law of the UK.

3.2.9 R A *firm* must include, in the materials it provides to the *FCA* under IFPRU 3.2.8 R, a properly reasoned legal opinion from an individual appropriately qualified in the relevant *third country*.

Notification of issuance of own funds instruments

3.2.10 R A *firm* must notify the *FCA* of the following:

(1) its intention; or

(2) the intention of another member of its *group* that is not a *firm*, but is included in the supervision on a *consolidated basis* of the *firm*;

to issue a capital instrument that it believes will qualify under the *EU CRR* as *own funds* other than a *common equity tier 1 capital* at least one *month* before the intended date of issue.

3.2.11 R A *firm* does not have to give notice under IFPRU 3.2.10 R if the capital instrument is:

(1) an ordinary *share*; or

(2) a debt instrument issued under a debt securities programme under which the *firm* or *group* member has previously issued and the *firm* has notified the *FCA*, in accordance with IFPRU 3.2.10 R, prior to a previous issuance under the programme.

3.2.12 R When giving notice, the *firm* must provide:

(1) details of the amount and type of *own funds* the *firm* is seeking to raise through the intended issue and whether the capital instrument is intended to be issued to external investors or other members of its *group*;

(2) a copy of the term sheet and details of any features of the capital instrument which are novel, unusual or different from a capital instrument of a similar nature previously issued by the *firm* or widely available in the market;

(3) confirmation from a member of the *firm*'s senior management responsible for authorising the intended issue or, in the case of an issue by another *group* member, for the issue's inclusion in the *firm*'s consolidated *own funds*, that the capital instrument meets the conditions for qualification as an *own funds* item; and

(4) a properly reasoned legal opinion from an appropriately qualified individual confirming that the capital instrument meets the conditions for qualification as the relevant type of *own funds*.

3.2.13 R A *firm* must notify the *FCA* in writing, no later than the date of issue of its intention, or the intention of another member of its *group* that is not a *firm* included in the supervision on a *consolidated basis* of the *firm*, to issue a capital instrument described in IFPRU 3.2.11 R.

3.2.14 R When giving notice under IFPRU 3.2.13 R, the *firm* must provide:

(1) confirmation that the terms of the capital instrument have not changed since the previous issue by the *firm* of that type of capital instrument; and

(2) the information in IFPRU 3.2.12 R (1) and IFPRU 3.2.12 R (3).

3.2.15 R The *firm* must promptly notify the *FCA* of any change to the intended date of issue, amount of issue, type of investors, type of *own funds* or any other feature of the capital instrument to that previously notified to the *FCA* under IFPRU 3.2.10 R or IFPRU 3.2.13 R.

Notification of amendments to own funds instruments

3.2.16 R A *firm* must notify the *FCA* of its intention, or the intention of another member of its *group* that is not a *firm* included in the supervision on a *consolidated basis* of the *firm*, to amend or otherwise vary the terms of any *own funds* instrument included in its *own funds* or the *own funds* of its consolidated *group* at least one *month* before the intended date of such amendment or other variation.

Notification of reduction of own funds

3.2.17 R A *firm* must notify the *FCA* of its intention, or the intention of another member of its *group* included in the supervision on a *consolidated basis* of the *firm*, to carry out any of the actions described in article 77 of the *EU CRR* (Conditions for reducing own funds) for an *own funds* instrument.

Common equity tier 1 capital: partnership capital account

3.2.18 G A partner's account of a *firm* that is a partnership:

(1) into which capital contributed by partners is paid; and

(2) from which under the terms of the partnership agreement an amount representing capital may be withdrawn by a partner only if:

(a) he ceases to be a partner and an equal amount is transferred to another such account by his former partners or any *person* replacing him as their partner; or

(b) the partnership is wound up or otherwise dissolved; or

(c) the *firm* has ceased to be *authorised* or no longer has a *Part 4A permission*;

may be considered as meeting the purposes of article 28(1)(e) (perpetual) and (f) (reduction or repayment) of the *EU CRR*.

Common equity tier 1 capital: eligible LLP members' capital

3.2.19 G A member's account of a *firm* that is a *limited liability partnership*:

(1) into which capital contributed by the members is paid; and

(2) from which, under the terms of the *limited liability partnership* agreement, an amount representing capital may be withdrawn by a partner only if:

(a) he ceases to be a member and an equal amount is transferred to another such account by his former fellow members or any *person* replacing him as a member;

(b) the *limited liability partnership* is wound up or otherwise dissolved; or

(c) the *firm* has ceased to be *authorised* or no longer has a *Part 4A permission*;

may be considered as meeting the purposes of article 28(1)(e) (perpetual) and (f) (reduction or repayment) of the *EU CRR*.

Variable capital calculation for collective portfolio management investment firms

3.2.20 G When a *collective portfolio management investment firm* calculates the total risk exposure amount in article 92(3) of the *EU CRR*, the *own funds requirements* referred to in article 92(3)(a) (Risk-weighted exposure amount for credit risk and dilution risk) and article 92(3)(b) (Risk-weighted exposure amount for position risk) should include only those arising from its *designated investment business*. For this purpose, *managing an AIF* or *managing a UCITS* is excluded from *designated investment business*.

3

3.3 Basel 1 floor

Permission not to apply the Basel 1 floor

3.3.1 G The *FCA* does not expect that it will waive the application of the Basel 1 floor as contemplated in article 500(2) of the *EU CRR*.

Chapter 4

Credit risk

4

4.1 Application and purpose

Application

4.1.1 R IFPRU 4 applies to an *IFPRU investment firm*, unless it is an *exempt IFPRU commodities firm*.

Purpose

4.1.2 G This chapter:

(1) implements article 78 of *CRD*;

(2) contains the *rules* that exercise the discretion afforded to the *FCA* as *competent authority* under articles 115, 119(5), 124(2), 125(3), 126(2), 178(1)(b), 244(2), 245(2), 286(2), 298(4) and 380 of the *EU CRR*; and

(3) contains the *guidance* in relation to the IRB approach, *securitisation*, counterparty credit risk and *credit risk mitigation*.

4

4.2 Standardised approach

Standardised approach

4.2.1 R For the purposes of article 115 of the *EU CRR* (Exposures to regional governments or local authorities), a *firm* may treat *exposures* to the following regional governments as *exposures* to the *UK* central government:

(1) The Scottish Parliament;

(2) The National Assembly for Wales; and

(3) The Northern Ireland Assembly.

Risk weights

4.2.2 G Where the *FCA* has published evidence showing that a well-developed and long-established residential property market is present in that territory with loss rates which do not exceed the limits in article 125(3) of the *EU CRR* (Exposures fully and completely secured by mortgages on residential property), a *firm* does not need to meet the condition in article 125(2)(b) of the *EU CRR* in order to consider an *exposure*, or any part of an *exposure*, as fully and completely secured for the purposes of article 125(1) of the *EU CRR*.

Criteria for certain exposures secured by mortgages on commercial immovable property

4.2.3 R For the purposes of articles 124(2) and 126(2) of the *EU CRR*, and in addition to the conditions in those regulations, a *firm* may only treat *exposures* as fully and completely secured by mortgages on commercial immovable property located in the *UK* in line with article 126 where annual average losses stemming from lending secured by mortgages on commercial property in the UK did not exceed 0.5% of risk-weighted exposure amounts over a representative period. A *firm* must calculate the *loss* level in this *rule* on the basis of the aggregate market data for commercial property lending published by the *FCA* in line with article 101(3) of the *EU CRR*.

4.2.4 R For the purpose of this *rule*, a representative period shall be a time horizon of sufficient length and which includes a mix of good and bad years.

Exposures to institutions

4.2.5 G The *FCA* confirms that, in relation to the concessionary treatment set out in article 119(5) of the *EU CRR*, there are no *financial institutions* currently authorised and supervised by it (other than those to which the *EU CRR* applies directly) that are subject to prudential requirements that it considers to be comparable in terms of robustness to those applied to *institutions* under the *EU CRR*.

[**Note**: article 119(5) of the *EU CRR*]

Retail exposures

4.2.6 G Where an *exposure* is denominated in a currency other than the euro, the *FCA* expects a *firm* to use appropriate and consistent exchange rates to determine compliance with relevant thresholds in the *EU CRR*. Accordingly, a *firm* should calculate the euro equivalent value of the *exposure* for the purposes of establishing compliance with the aggregate monetary limit of €1 million for retail *exposures* using a set of exchange rates the *firm* considers to be appropriate. The *FCA* expects a *firm's* choice of exchange rate to have no obvious bias and to be derived on the basis of a consistent approach (see article 123(c) of the *EU CRR*).

Exposures fully and completely secured by mortgages on residential property: Ijara mortgages

4.2.7 G The *FCA* considers an Ijara mortgage to be an example of an *exposure* to a tenant under a property leasing transaction concerning residential property under which the *firm* is the lessor and the tenant has an option to purchase. Accordingly, the *FCA* expects *exposures* to Ijara mortgages to be subject to all of the requirements that apply to *exposures* secured by mortgages on residential property, including in respect of periodic property revaluation (see articles 124 and 125 of the *EU CRR*).

Lifetime mortgages

4.2.8 G The *FCA* expects a *firm* with exposure to a *lifetime mortgage* to inform the *FCA* of the difference in the *own funds requirements* on those *exposures* under the *EU CRR* and the credit risk capital requirement that would have applied under BIPRU 3.4.56A R.The *FCA* will use this information in its consideration of relevant risks in its supervisory assessment of the *firm* (see articles 124, 125 and 208 of the *EU CRR*).

Exposures in default

4.2.9 G When determining the portion of a past due item that is secured, the *FCA* expects the secured portion of an *exposure* covered by a mortgage indemnity product that is eligible for *credit risk mitigation* purposes under Part Three, Title II, Chapter 4 of the *EU CRR* (Credit risk mitigation) to qualify as an eligible guarantee (see article 129(2) of the *EU CRR*).

Items associated with particularly high risk

4.2.10 G When determining whether *exposures* in the form of units or shares in a *CIU* are associated with particularly high risk, the *FCA* expects the following features would be likely to give rise to such risk:

(1) an absence of external credit assessment of such *CIU* from an *ECAI* recognised under article 132(2) of the *EU CRR* (Items representing

securitisation positions) and where such *CIU* has specific features (such as high levels of leverage or lack of transparency) that prevent it from meeting the eligibility criteria in article 132(3) of the *EU CRR* (Items associated with particular high risk); or

(2) a substantial element of the *CIU's* property is made up of items that would be subject to a risk weight of more than 100%, or the mandate of a *CIU* would permit it to invest in a substantial amount of such items.

4.2.11 G The *FCA* expects a *firm's* assessment of whether types of *exposure* referred to in article 128(3) of the *EU CRR* are associated with particularly high risk to include consideration of *exposures* arising out of a venture capital business (whether the *firm* itself carries on the venture capital business or not) . The *FCA* considers "venture capital business" to include the business of carrying on any of the following:

(1) advising on investments, *managing investments*, *arranging (bringing about) deals in investments* in or *making arrangements with a view to transactions in investments* in *venture capital investments*;

(2) advising on investments or *managing investments* in relation to portfolios, or *establishing, operating or winding up a collective investment scheme*, where the portfolios or collective investment schemes (apart from funds awaiting investment) invest only in *venture capital investments*;

(3) any *custody* activities provided in connection with the activities in (1) or (2); and

(4) any related *ancillary activities*.

Mapping of ECAIs credit assessments

4.2.12 G Until such time as the European Commission adopts implementing technical standards drafted by the European Supervisory Authorities Joint Committee to specify for all *ECAIs* the relevant credit assessments of the *ECAI* that correspond to credit quality steps, the *FCA* expects a *firm* to continue to have regard to the table mapping the credit assessments of certain *ECAIs* to credit quality steps produced in accordance with regulation 22(3) of the Capital Requirements Regulations 2006. For mapping of the credit quality step to the credit assessments of eligible *ECAIs*, refer to: http://www.fca.org.uk.

4

4.3 Guidance on internal ratings based approach: high level material

4.3.1 G Responsibility for ensuring that internal models are appropriately conservative and that approaches are compliant with the *EU CRR* rests with the *firm* itself.

4.3.2 G A *significant IFPRU firm* should consider developing internal credit risk assessment capacity and to increase use of the internal ratings based approach for calculating *own funds requirements* for credit risk where its *exposures* are material in absolute terms and where it has at the same time a large number of material counterparties. This provision is without prejudice to the fulfilment of criteria laid down in Part Three, Title I, Chapter 3, Section 1 of the *EU CRR* (IRB approach).

[**Note**: article 77(1) of *CRD*]

4.3.3 G The *FCA* will, taking into account the nature, scale and complexity of a *firm*'s activities, monitor that it does not solely or mechanistically rely on external credit ratings for assessing the creditworthiness of an entity or *financial instrument*.

[**Note**: article 77(2) of *CRD*]

Application of requirements to EEA groups applying the IRB approach on a unified basis

4.3.4 G Article 20(6) of the *EU CRR* states that, where the IRB approach is used on a unified basis by those entities which fall within the scope of article 20(6) (EEA group), the *FCA* is required to permit certain IRB requirements to be met on a collective basis by members of that group. In particular, the *FCA* considers that, where a *firm* is reliant upon a rating system or data provided by another member of its group, it will not meet the condition that it is using the IRB approach on a unified basis unless:

(1) the *firm* only does so to the extent that it is appropriate, given the nature and scale of the *firm*'s business and portfolios and the *firm*'s position within the group;

(2) the integrity of the *firm*'s systems and controls is not adversely affected;

(3) the outsourcing of these functions meets the requirements of *SYSC*; and

(4) the abilities of the *FCA* and the *consolidating supervisor* of the group to carry out their responsibilities under the *EU CRR* are not adversely affected.

4.3.5 G Prior to reliance being placed by a *firm* on a rating system or data provided by another member of the group, the *FCA* expects the proposed arrangements to have been explicitly considered, and found to be appropriate, by the *governing body* of the *firm*.

4.3.6 G If a *firm* uses a rating system or data provided by another group member, the *FCA* would expect the *firm's governing body* to delegate those functions formally to the persons or bodies that are to carry them out.

Materiality of non-compliance

4.3.7 G Where a *firm* seeks to demonstrate to the *FCA* that the effect of its non-compliance with the requirements of Part Three, Title II Chapter 3 of the *EU CRR* (Internal ratings based approach) is immaterial under article 146(b) of the *EU CRR* (Measures to be taken where the requirements cease to be met), the *FCA* expects the *firm* to have taken into account all instances of non-compliance with the requirements of the IRB approach and to have demonstrated that the overall effect of non-compliance is immaterial.

Corporate governance

4.3.8 G (1) Where the *firm*'s rating systems are used on a unified basis under article 20(6) of the *EU CRR*, the *FCA* considers that the governance requirements in article 189 of the *EU CRR* can only be met if the subsidiaries have delegated to the *governing body* or designated committee of the *EEA parent institution*, *EEA parent financial holding company* or *EEA parent mixed financial holding company* responsibility for approval of the *firm*'s rating systems.

(2) The *FCA* expects an appropriate individual in a *significant-influence function* role to provide to the *FCA* on an annual basis written attestation that the rating system permissions required by the *EU CRR* have been carried out appropriately.

[**Note**: see articles 189 and 20(6) of the *EU CRR* and article 3(1)(7) of *CRD*]

Permanent partial use: policy for identifying exposures

4.3.9 G The *FCA* expects a *firm* seeking to apply the Standardised Approach on a permanent basis to certain *exposures* to have a well-documented policy explaining the basis on which *exposures* are to be selected for permanent exemption from the IRB approach. This policy should be provided to the *FCA* when the *firm* applies for permission to use the IRB approach and maintained thereafter. Where a *firm* also wishes to undertake sequential implementation, the *FCA* expects the *firm's* roll-out plan to provide for the continuing application of that policy on a consistent basis over time.

4

Permanent partial use: exposures to sovereigns and institutions

4.3.10 G

(1) The *FCA* may permit the exemption of *exposures* to sovereigns and *institutions* under article 150(1)(a) and (b) of the *EU CRR* respectively only if the number of material counterparties is limited and it would be unduly burdensome to implement a rating system for such counterparties.

(2) The *FCA* considers that the 'limited number of material counterparties' test is unlikely to be met if for the UK group total outstandings to 'higher risk' sovereigns and institutions exceed either £1bn or 5% of total assets (other than for temporary fluctuations above these levels). For these purposes, 'higher risk' sovereigns and *institutions* are considered to be those that are unrated or carry ratings of BBB+ (or equivalent) or lower. In determining whether to grant this exemption, the *FCA* will also consider whether a *firm* incurs *exposures* to 'higher risk' counterparties which are below the levels set out but are outside the scope of its core activities.

(3) In respect of the 'unduly burdensome' condition, the *FCA* considers that an adequate, but not perfect, proxy for the likely level of expertise available to a *firm* is whether its group has a *trading book*. Accordingly, if a *firm*'s group does not have a *trading book*, the *FCA* is likely to accept the argument that it would be unduly burdensome to implement a rating system.

Permanent partial use: non-significant business units and immaterial exposure classes and types

4.3.11 G

Where a *firm* wishes permanently to apply the Standardised Approach to certain business units on the grounds that they are non-significant and/or certain *exposure* classes or types of *exposures* on the grounds that they are immaterial in terms of size and perceived risk profile, the *FCA* expects to permit a *firm* to make use of this exemption only to the extent that the risk-weighted exposure amount calculated under article 92(3)(a) and (f) of the *EU CRR* that are based on the Standardised Approach (insofar as they are attributable to the *exposures* to which the Standardised Approach is permanently applied) would be no more than 15% of the risk-weighted exposure amount calculated under article 92(3)(a) and (f) of the *EU CRR*, based on whichever of the Standardised Approach and the IRB Approach would apply to the *exposures* at the time when the calculation is being made.

4.3.12 G

The following points set out the level at which the *FCA* expects the 15% test to applied for a *firm* that is a member of a *group*:

(1) if a *firm* is part of a group subject to consolidated supervision in the *EEA* and for which the *FCA* is the *consolidating supervisor*, the calculations in (1) are carried out with respect to the wider *group*;

(2) if a *firm* is part of a group subject to consolidated supervision in the *EEA* and for which the *FCA* is not the *consolidating supervisor* the calculation in (1) would not apply but the requirements of the *consolidating supervisor* relating to materiality will need to be met for the wider *group*;

(3) if the *firm* is part of a sub-group subject to consolidated supervision in the *EEA* and part of a wider third-country group subject to equivalent supervision by a regulatory authority outside of the *EEA*, the calculation in (1) would not apply but the requirements of the consolidating or lead regulator relating to materiality would need to be met for both the sub-group and the wider *group*; and

(4) if the *firm* is part of a sub-group subject to consolidated supervision in the *EEA* and is part of a wider third-country group that is not subject to equivalent supervision by a regulatory authority outside of the *EEA*, then the calculation in (1) would apply for the wider *group* if supervision by analogy is applied and for the sub-group if other alternative supervisory techniques are applied.

4.3.13 G Whether a third-country group is subject to equivalent supervision, whether it is subject to supervision by analogy or whether other alternative supervisory techniques apply, is decided in accordance with article 127 of *CRD* (Assessment of equivalence of third countries' consolidated supervision). (See article 150(1)(c) of the *EU CRR*.)

Permanent partial use: identification of connected counterparties

4.3.14 G Where a *firm* wishes to permanently apply the Standardised Approach to *exposures* to connected counterparties in accordance with article 150(1)(e) of the *EU CRR*, the *FCA* would normally expect to grant permission to do so only if the *firm* had a policy that provided for the identification of connected counterparties *exposures* that would be permanently exempted from the IRB approach and also identified connected counterparty *exposures* (if any) that would not be permanently exempted from the IRB approach. The *FCA* expects a *firm* to use the IRB approach either for all of its intra-group *exposures* or none of them (see article 150(1)(e) of the *EU CRR*).

Sequential implementation following significant acquisition

4.3.15 G In the event that a *firm* with IRB permission acquires a significant new business, it should discuss with the *FCA* whether sequential roll-out of the *firm*'s IRB approach to these *exposures* would be appropriate. In addition, the *FCA* would expect to review any existing time period and conditions for sequential roll-out and determine whether these remain appropriate (see article 148 of the *EU CRR*).

Classification of retail exposures: qualifying revolving retail exposures (QRRE)

4.3.16 G (1) Article 154(4)(d) of the *EU CRR* (Risk-weighted exposure amounts for retail exposures) specifies that, for an *exposure* to be treated as a qualifying revolving retail *exposure* (QRRE), it needs to exhibit relatively low volatility of loss rates. A *firm* should assess the volatility of loss rates for the QRRE portfolio relative to the volatilities of loss rates of other relevant types of retail *exposures* for these purposes. Low volatility should be demonstrated by reference to data on the mean and standard deviation of loss rates over a time period that can be regarded as representative of the long-run performance of the portfolios concerned.

(2) Article 154(4)(e) of the *EU CRR* specifies that, for an *exposure* to be treated as a QRRE, this treatment should be consistent with the underlying risk characteristic of the sub-portfolio. The *FCA* considers that a sub-portfolio consisting of credit card or overdraft obligations will usually meet this condition and that it is unlikely that any other type of retail *exposure* will do so. If a *firm* wishes to apply the treatment in article 154 (4) of the *EU CRR* to product types other than credit card or overdraft obligations, the *FCA* expects it to discuss this with the *FCA* before doing so.

Documentation

4.3.17 G The *FCA* expects a *firm* to ensure that all documentation relating to its rating systems (including any documentation referenced in this chapter or required by the *EU CRR* that relate to the IRB approach) is stored, arranged and indexed in such a way that it could make them all, or any subset thereof, available to the *FCA* immediately on demand or within a short time thereafter.

4.4 Internal ratings based approach: overall requirements for estimation

High-level expectations

4.4.1 G In order to be able to determine that the requirements in article 144(1) of the *EU CRR* have been met, the *FCA* would typically have the high-level expectations set out in this section.

4.4.2 G The information that a *firm* produces or uses for the IRB approach should be reliable and take proper account of the different users of the information produced (customers, shareholders, regulators and other market participants).

4.4.3 G A *firm* should establish quantified and documented targets and standards, against which it should test the accuracy of data used in its rating systems. Such tests should cover:

(1) a report and accounts reconciliation, including whether every *exposure* has a PD, LGD and, if applicable, conversion factor for reporting purposes;

(2) whether the *firm*'s risk control environment has key risk indicators for the purpose of monitoring and ensuring data accuracy;

(3) whether the *firm* has an adequate business and information technology infrastructure with fully documented processes;

(4) whether the *firm* has clear and documented standards on ownership of data (including inputs and manipulation) and timeliness of current data (daily, monthly, real time); and

(5) whether the *firm* has a comprehensive quantitative audit programme.

4.4.4 G In respect of data inputs, the testing for accuracy of data (including the reconciliation referred to above) should be sufficiently detailed so that, together with other available evidence, it gives reasonable assurance that data input into the rating system is accurate, complete and appropriate. The *FCA* considers that input data fails to meet the required standard if it gives rise to a serious risk of material misstatement in the *own funds requirement* either immediately or subsequently.

4

4.4.5 G In respect of data outputs, a *firm* (as part of the reconciliation referred to above) should be able to identify and explain material differences between the outputs produced under accounting standards and those produced under the requirements of the IRB approach, including in relation to areas that address similar concepts in different ways (eg, expected loss and accounting provisions).

4.4.6 G A *firm* should have clear and documented standards and policies about the use of data in practice (including information technology standards) which should, in particular, cover the *firm's* approach to the following:

(1) data access and security;

(2) data integrity, including the accuracy, completeness, appropriateness and testing of data; and

(3) data availability.

[**Note**: article 144(1)(a) of the *EU CRR*)

Rating systems: policies

4.4.7 G For the *FCA* to be satisfied that a *firm* documents its ratings systems appropriately, in accordance with article 144(1)(e) of the *EU CRR*, it would expect a *firm* to be able to demonstrate that it has an appropriate policy for any ratings system in relation to:

(1) any deficiencies caused by its not being sensitive to movements in fundamental risk drivers or for any other reason;

(2) the periodic review and action in the light of such review;

(3) providing appropriate internal guidance to staff to ensure consistency in the use of the rating system, including the assignment of *exposures* or facilities to pools or grades;

(4) dealing with potential weaknesses of the rating system;

(5) identifying appropriate and inappropriate uses of the rating system and acting on that identification;

(6) novel or narrow rating approaches; and

(7) ensuring the appropriate level of stability over time of the rating system.

[**Note**: article 144(1)(a) and (e) of the *EU CRR*)

Collection of data

4.4.8 G To be satisfied that the requirements in article 179(1) of the *EU CRR* are met, the *FCA* expects a *firm* to collect data on what it considers to be the main drivers of the risk parameters of probability of default (PD), loss given default (LGD), conversion factors (CFs) and expected loss (EL) for each group of obligors or facilities, to document the identification of the main drivers of risk parameters, and be able to demonstrate that the process of identification is reasonable and appropriate.

4.4.9 G In its processes for identifying the main drivers of risk parameters, the *FCA* expects that a *firm* should set out its reasons for concluding that the data sources chosen provide in themselves sufficient discriminative power and accuracy and why additional potential data sources do not provide relevant and reliable information that would be expected materially to improve the discriminative power and accuracy of its estimates of the risk parameter in question. This process need not necessarily require an intensive analysis of all factors.

[**Note**: article 179(1)(a), (d) and (e) of the *EU CRR*)

Data quality

4.4.10 G To demonstrate that rating systems provide for meaningful assessment, the *FCA* expects that a *firm*'s documentation relating to data should include clear identification of responsibility for data quality. A *firm* should set standards for data quality, aim to improve them over time and measure its performance against those standards. Furthermore, a *firm* should ensure that its data is of high enough quality to support its risk management processes and the calculation of its *own funds requirements* (see article 175(1) of the *EU CRR*).

Use of models and mechanical methods to produce estimates of parameters

4.4.11 G Further detail of standards that the *FCA* would expect a *firm* to meet when it assesses compliance with article 174 of *EU CRR* are set out in the sections on probability of default (PD), loss given default (LGD) and exposure at default (EAD).

4.4.12 G In assessing whether the external data used by a *firm* to build models is representative of its actual obligors or *exposures*, the *FCA* expects a *firm* to consider whether this data is appropriate to its own experience and whether adjustments are necessary (see article 174 of the *EU CRR*).

Calculation of long averages PD, LGD and EAD

4.4.13 G To estimate PDs that are long run averages of one-year default rates for obligor grades or pools, the *FCA* expects a *firm* to estimate expected default rates for the grade/pool over a representative mix of good and bad economic periods, rather than simply taking the historic average of default rates actually incurred by the *firm* over a period of years. The *FCA* expects that a long run estimate would be changed when there is reason to believe that the existing long run estimate is no longer accurate, but that it would not be automatically updated to incorporate the experience of additional years as these may not be representative of the long run average (see article 180 of the *EU CRR*).

4.4.14 G To demonstrate compliance with article 144(1) of the *EU CRR*, the *FCA* expects a *firm* to take into account the following factors in understanding differences between their historic default rates and their PD estimates, and in adjusting the calibration of their estimates as appropriate:

(1) the rating philosophy of the system and the economic conditions in the period over which the defaults have been observed;

(2) the number of defaults, as a low number is less likely to be representative of a long run average. Moreover, where the number of internal defaults is low, there is likely to be a greater need to base PDs on external default data as opposed to purely internal data;

(3) the potential for under-recording of actual defaults; and

(4) the level of conservatism applied.

4.4.15 G The *FCA* expects a *firm* that is unable to produce a long run estimate, as described above, to consider what action it would be appropriate for it to take to comply with article 180(1)(a) of the *EU CRR*. In some circumstances, it may be appropriate for a *firm* to need to amend its rating system so that the PD used as an input into the IRB *own funds requirement* is an appropriately conservative estimate of the actual default rate expected over the next year. However, such an approach is not likely to be appropriate where default rates are dependent on the performance of volatile collateral. (See articles 179(1)(f) and 180(1)(a) of the *EU CRR*).

4.4.16 G In accordance with articles 181(1)(b) and 182(1)(b) of the *EU CRR*, where the estimates appropriate for an economic downturn are more conservative than the long run average, the *FCA* expects the estimate for each of these parameters to represent the LGD or CF expected, weighted by the number of defaults, over the downturn period. Where this is not the case, the *FCA* expects the estimate to be used to be the expected LGD or CF, weighted by the number of defaults, over a representative mix of good and bad economic periods (see articles 179, 181 and 182 of the *EU CRR*).

Assignment to grades or pools

4.4.17 G To demonstrate that a rating system provides for a meaningful differentiation of risk and accurate and consistent quantitative estimates of risk, the *FCA* expects a *firm* would have regard to the sensitivity of the rating to movements in fundamental risk drivers, in assigning *exposures* to grades or pools within a rating system (see article 171 of the *EU CRR*).

4

4.5 Internal ratings based approach: definition of default

Identification of obligors

4.5.1 G The *FCA* expects that if a *firm* ordinarily assigns *exposures* in the corporate, *institution* or central government and central bank *exposure* classes to a member of a *group*, substantially on the basis of membership of that *group* and a common group rating, and the *firm* does so in the case of a particular obligor group, the *firm* should consider whether members of that *group* should be treated as a single obligor for the purpose of the definition of default in article 178(1) of the *EU CRR*.

4.5.2 G The *FCA* would not expect a *firm* to treat an obligor as part of a single obligor under IFPRU 4.5.1 G if the *firm* rates its *exposures* on a standalone basis or if its rating is notched. (For these purposes, a rating is notched if it takes into account individual risk factors or otherwise reflects risk factors that are not applied on a common group basis.) Accordingly, if a *group* has two members which are separately rated, the *FCA* will not expect that the default of one will necessarily imply the default of the other.

Days past due

4.5.3 G Under article 178(1)(b) of the *EU CRR*, the *FCA* is empowered to replace 90 days with 180 days in the days past due component of the definition of default for *exposures* secured by residential or SME commercial real estate in the retail exposure class, as well as *exposures* to public sector entities (PSEs).

4.5.4 G The *FCA* would expect to replace 90 days with 180 days in the days past due component of the definition of default for *exposures* secured by residential real estate in the retail *exposure* class, and/or for *exposures* to PSEs, where this was requested by the *firm*. Where this occurred, it would be specified in the *firm*'s IRB permission.

Unlikeliness to pay in distressed restructuring

4.5.5 G The *FCA* expects that a credit obligation be considered as a distressed restructuring if an independent third party, with expertise in the relevant area, would not be prepared to provide financing on substantially the same terms and conditions (see article 178(2)(d) of the *EU CRR*).

Returning to performing status

4.5.6 G To be satisfied that a *firm* complies with the documentation requirements in article 175(3) of the *EU CRR*, the *FCA* expects a *firm* should have a clear and documented policy for determining whether an exposure that has been in default should subsequently be returned to performing status (see article 175(3) of the *EU CRR*).

4.6 Internal ratings based approach: probability of default

Rating system philosophy

4.6.1 G 'Rating philosophy' describes the point at which a rating system sits on the spectrum between the stylised extremes of a point in time (PiT) rating system and a through-the-cycle (TTC) rating system. To explain these concepts:

(1) PiT: a *firm* seeks to explicitly estimate default risk over a fixed period, typically one year. Under such an approach, the increase in default risk in a downturn results in a general tendency for migration to lower grades. When combined with the fixed estimate of the long-run default rate for the grade, the result is a higher *own funds requirement*. Where data are sufficient, grade level default rates tend to be stable and relatively close to the PD estimates; and

(2) TTC: a *firm* seeks to remove cyclical volatility from the estimation of default risk, by assessing borrowers' performance across the economic cycle. TTC ratings do not react to changes in the cycle, so there is no consequent volatility in capital requirements. Actual default rates in each grade diverge from the PD estimate for the grade, with actual default rates relatively higher at weak points in the cycle and relatively lower at strong points.

4.6.2 G Most rating systems sit between these two extremes. Rating philosophy is determined by the cyclicality of the drivers/criteria used in the rating assessment and should not be confused with the requirement for grade level PDs to be "long run". The calibration of even the most PiT rating system needs to be targeted at the long run default rates for its grades; the use of long run default rates does not convert such a system into one producing TTC ratings or PDs

4.6.3 G A *firm* should understand where its rating systems lie on the PiT/TTC spectrum to enable it to estimate how changes in economic conditions will affect its IRB *own funds requirements* and it should be able to compare the actual default rates incurred against the default rate expected over the same period given the economic conditions pertaining, as implied by its PD estimate.

Use of variable scalar approaches

4.6.4 G The term "variable scalar" is used to describe approaches in which the outputs of an underlying, relatively PiT, rating system are transformed to produce final PD estimates used for regulatory capital requirements that are relatively non-cyclical. Typically, this involves basing the resulting requirement on the long run default rate of the portfolio or its segments.

4.6.5 G Article 169(3) of the *EU CRR* allows the use of direct estimates of PDs, although such a measure could be assessed over a variety of different time horizons which the *EU CRR* does not specify. Accordingly, the *FCA* considers that it acceptable in principle to use methodologies of this type in lieu of estimation of long-run averages for the grade/pool/score of the underlying rating system, where the following conditions are met. Meeting these conditions requires a *firm* using the variable scalar approach to have a deep understanding of how and why its default rates vary over time:

(1) a *firm* meets the following four principles which address the considerable conceptual and technical challenges to be overcome in order to carry out variable scalar adjustments in an appropriate way:

Principle 1: both the initial calculations of, and subsequent changes to, the scalar must be able to take account of changes in default risk that are not purely related to the changes in the cycle;

Principle 2: a *firm* must be able accurately to measure the long-run default risk of its portfolio; this must include an assumption that there are no changes in the business written;

Principle 3: a *firm* must use a data series of appropriate length in order to provide a reasonable estimate of the long-run default rate in IFPRU 4.4.13 G (Calculation of long averages PD, LGD and EAD); and

Principle 4: a *firm* must be able to demonstrate the appropriateness of the scaling factor being used across a portfolio;

(2) stress testing includes a stress test covering the downturn scenario outlined in IFPRU 2.2 (Internal capital adequacy assessment process)] based on the PDs of the underlying PiT rating system, in addition to the stress test based on the parameters used in the Pillar 1 *own funds requirements* calculation (ie, the portfolio level average long-run default rates); and

(3) a *firm* is able to understand and articulate upfront how the scaling factor would vary over time in order to achieve the intended effect.

4.6.6 G The *FCA* will not permit a *firm* using a variable scalar approach to revert to using a PiT approach during more benign economic conditions.

4.6.7 G Principle 1 (in IFPRU 4.6.5 G) is the most important and challenging to achieve as it requires an ability to be able to distinguish movements not related to the economic cycle, from changes purely related to the economic cycle, and not to average these away. This is because a variable scalar approach removes the ability of a rating system to take account automatically of changes in risk through migration between its grades.

4.6.8 G Accordingly, the *FCA* expects a *firm* using a variable scalar approach should adopt a PD that is the long-run default rate expected over a representative mix of good and bad economic periods, assuming that the current lending conditions including borrower mix and attitudes and the *firm*'s lending policies remain unchanged. If the relevant lending conditions or policies change, then the *FCA* would expect the long-run default rate to change (see article 180(1)(a), (b) and (2)(a) of the *EU CRR*).

Variable scalar considerations for retail portfolios

4.6.9 G The *FCA* considers that, until more promising account level arrears data is collected, enabling *firms* to better explain the movement in their arrears rate over time, the likelihood of *firms* being able to develop a compliant variable scalar approach for non-mortgage retail portfolios is low. This is because of the difficulty that *firms* have in distinguishing between movements in default rates that result from cyclical factors and those that result from non-cyclical reasons for these portfolios. In practice, the rest of this section applies to residential mortgage portfolios.

4.6.10 G For the purposes of this subsection 'non-mortgage retail portfolios' refers to non-mortgage lending to individuals (eg, credit cards, unsecured personal loans, auto-finance) but does not include portfolio of *exposures* to small and medium-sized entities (SMEs in the retail *exposure* class).

4.6.11 G The *FCA* considers that one variable scalar approach, potentially compliant with the four principles in IFPRU 4.6.5 G, could involve:

(1) segmenting a portfolio by its underlying drivers of default risk; and

(2) estimating separate long-run default rates for each of these segmented pools.

Segmentation

4.6.12 G A *firm* that applied the segmentation approach properly could satisfy both Principle 1 and Principle 4 (IFPRU 4.6.5 G). The choice of the basis of segmentation and the calibration of the estimated long-run default rate for the segments would both be of critical importance.

4.6.13 G Segmentation should be done on the basis of the main drivers of both willingness and ability to pay. In the context of residential mortgages, an example of the former is the amount of equity in the property and an example of the latter is the ratio of debt to income. The *FCA* expects a *firm* to:

(1) incorporate an appropriate number of drivers of risk within the segmentation to maximise the accuracy of the system;

(2) provide detailed explanations supporting its choices of drivers, including an explanation of the drivers it has considered and chosen not to use; and

(3) ensure that the drivers reflect its risk processes and lending policy, and is therefore not chosen using only statistical criteria (ie a judgemental assessment of the drivers chosen must be applied).

[**Note**: article 179(1)(d) of the *EU CRR*]

4.6.14 G To the extent that the basis of segmentation is not sufficient completely to explain movements in non-cyclical default risk, the long-run default rate for that segment will not be stable (eg, a change in the mix of the portfolio within the segment could change the long-run default rate). In such cases, the *FCA* would expect a *firm* to make a conservative compensating adjustment to the calibration of the long-run average PD for the affected segments and be able to demonstrate that the amount of judgement required to make such adjustments is not excessive. Where judgement is used, considerable conservatism may be required. The *FCA* expects conservatism applied for this reason not to be removed as the cycle changes.

Long-run default rate

4.6.15 G The *FCA* expects a *firm* to review and amend as necessary the long run default rate to be applied to each segment on a regular (at least an annual) basis. When reviewing the long run default rate to be applied to each segment, the *FCA* expects a *firm* to consider the extent to which:

(1) realised default rates are changing due to cyclical factors and the scaling factors needs to be changed;

(2) new information suggests that both the PiT PDs and the long run PDs should be changed; and

(3) new information suggests that the basis of segmentation should be amended.

4.6.16 G The *FCA* expects that, over time, the actual default rates incurred in each segment would form the basis of PD estimates for the segments. However, at the outset, the key calibration issue is likely to be the setting of the initial long-run default rate for each segment, as this will underpin the PD of the entire portfolio for some years to come. A *firm* should apply conservatism in this area and this is something on which the *FCA* is likely to focus on in model reviews.

Governance

4.6.17 G A *firm* should put in place a governance process to provide a judgemental overlay to assess its choices of segments, PD estimates and scalars, both initially and on a continuing basis. Moreover, where the basis of its estimation is a formulaic approach, the *FCA* considers that the act of either accepting or adjusting the estimate suggested by the formula would represent the exercise of judgement.

4.6.18 G A *firm* should consider what use it can make of industry information. However, the *firm* should be seeking to measure the absolute level of, and changes to, its own default risk, rather than changes in default risk relative to the industry. Given the potential for conditions to change across in the market as a whole, a *firm* should not draw undue comfort from the observation that its default risk is changing in the same way as the industry as a whole. Doing so would not allow it to meet Principle 1 in IFPRU 4.6.5 G.

Data considerations

4.6.19 G The *FCA* expects a *firm* to consider the following issues when seeking to apply a variable scalar approach for UK mortgages:

(1) in respect of Principle 2 (IFPRU 4.6.5 G), the commonly used Council for Mortgage Lenders database was based on arrears data and not defaults during a period, and the use of these data without further analysis and adjustment can undermine the accuracy of any calculations; and

(2) in respect of Principle 3 (IFPRU 4.6.5 G), the historical data time period chosen for use in the calculations will vary the long-run PDs, and thus *own funds requirements*, when there is no change in the underlying risk.

4.6.20 G The *FCA* expects a *firm* that is including mortgage arrears data as a proxy for default data to:

(1) carry out sensitivity analysis identifying the circumstances in which the assumption that arrears may be used as a proxy for default would produce inaccuracy in long-run PD estimates;

(2) set a standard for what might constitute a potentially significant level of inaccuracy, and demonstrate why, in practice, the use of this proxy would not result in any significant inaccuracy;

(3) establish a process for assessing the ongoing potential for inaccuracy, including thresholds beyond which the level of inaccuracy may no longer be insignificant; and

(4) consider the use of conservative adjustments to address the potential inaccuracy.

4.6.21 G When using historical mortgage data as a key input into variable scalar models, the *FCA* expects a *firm* to:

(1) carry out sensitivity analysis identifying the implications of using different cut-off dates for the start of the reference data set; and

(2) justify the appropriateness of its choice of cut-off date.

Retail exposures: obligor level definition of default

4.6.22 G Where a *firm* has not chosen to apply the definition of default at the level of an individual credit facility in accordance with article 178(1) of the *EU CRR*, the *FCA* expects it to ensure that the PD associated with unsecured *exposures* is not understated as a result of the presence of any collateralised *exposures*.

4.6.23 G The *FCA* expects the PD of a residential mortgage would typically be lower than the PD of an unsecured loan to the same borrower (see article 178(1) of the *EU CRR*).

Retail exposures: facility level definition of default

4.6.24 G Where a *firm* chooses to apply the definition of default at the level of an individual credit facility, in accordance with article 178(1) of the *EU CRR*, and a customer has defaulted on a facility, then default on that facility is likely to influence the PD assigned to that customer on other facilities. The *FCA* expects a *firm* to take this into account in its estimates of PD (see article 178(1) of the *EU CRR*).

Multi-country mid-market corporate PD models

4.6.25 G To ensure that a rating system provides a meaningful differentiation of risk and accurate and consistent quantitative estimates of risk, the *FCA* expects a *firm* to develop country-specific mid-market PD models. Where a *firm* develops multi-country mid-market PD models, the *FCA* expects the *firm* to be able to demonstrate that the model rank orders risk and predicts default rates for each country where it is to be used for *own funds requirements* calculation.

4.6.26 G The *FCA* expects a *firm* to have challenging standards in place to meaningfully assess whether a model rank orders risk and accurately predict default rates. These standards should specify the number of defaults that are needed for a meaningful assessment to be done.

4.6.27 G The *FCA* expects a *firm* to assess the model's ability to predict default rates using a time series of data (ie, not only based on one year of default data).

4.6.28 G In the *FCA*'s view, a model is not likely to be compliant where the *firm* cannot demonstrate that it rank orders risk and predicts default rates for each country, regardless of any apparent conservatism in the model.

Use of external rating agency grades

4.6.29 G The *FCA* expects a *firm* using a rating agency grades as the primary driver in its IRB models to be able to demonstrate (and document) compliance with the following criteria:

(1) the *firm* has its own internal rating scale;

(2) the *firm* has a system and processes in place that allow it to continuously collect and analyse all relevant information, and the 'other relevant information' considered by the *firm* in accordance with article 171(2) of the *EU CRR* reflects the information collected and analysed by the *firm* when extending credit to new or existing obligors;

(3) the 'other relevant information' considered by the *firm* is included in an IRB model in a transparent and objective way and is subject to

challenge. The *FCA* expects the *firm* to be able to demonstrate what information was used and why, how it was included and, if no additional information is included, to be able to document what information was discarded and why;

(4) the development of final grades includes the following steps:

(a) the *firm* takes into account all available information (eg,external agency grades and any 'other relevant information') prior to allocating obligors to internal grades and does not automatically assign obligors to grades based on the rating agency grade;

(b) any overrides are applied to these grades; and

(c) the *firm* has a system and processes in place that allows it to continuously collect and analyse final rating overrides;

(5) the grades to which obligors are assigned is reassessed at least annually. The *firm* is able to demonstrate how the grades are reassessed on a more frequent than annual basis when new relevant information becomes available;

(6) the *firm* can demonstrate that a modelling approach is being applied, both in terms of the choice of the rating agency grade as the primary driver and, where information is found materially and consistently to add to the internal rating grade, that they have incorporated this information as an additional driver. The *FCA* expects this work to be analytical (rather than entirely subjective) and could form part of the annual independent review of the model.

4.6.30 G In the *FCA's* view, if a *firm* does not have any additional information to add to the external ratings for the significant part of its portfolio then it will not be meeting the requirements for using an IRB approach.

Low default portfolios

4.6.31 G The *FCA* expects a *firm* to estimate PD for a rating system in line with this section where the *firm's* internal experience of defaults for that rating system was 20 defaults or fewer, and reliable estimates of PD cannot be derived from external sources of default data, including the use of market price-related data. In PD estimation for all *exposures* covered by the rating system, the *FCA* expects the *firm* to:

(1) use a statistical technique to derive the distribution of defaults implied by the *firm's* experience, estimating PDs (the "statistical PD") from the upper bound of a confidence interval set by the *firm* to produce conservative estimates of PDs in accordance with article 179(f) of the *EU CRR*;

(2) use a statistical techniques to derive the distribution of default which takes account, as a minimum, of the following modelling issues:

(a) the number of defaults and number of obligor years in the sample;

(b) the number of years from which the sample was drawn;

(c) the interdependence between default events for individual obligors;

4

(d) the interdependence between default rates for different years; and

(e) the choice of the statistical estimators and the associated distributions and confidence intervals;

(3) further adjust the statistical PD to the extent necessary to take account of the following:

(a) any likely differences between the observed default rates over the period covered by the *firm's* default experience and the long-run PD for each grade required by article 180(1)(a) and (2)(a) of the *EU CRR*; and

(b) any other information that indicates (taking into account the robustness and cogency of that information) that the statistical PD is likely to be an inaccurate estimate of PD.

4.6.32 G The *FCA* expects a *firm* to take into account only defaults that occurred during periods that are relevant to the validation under the *EU CRR* of the model or other rating system in question when determining whether there are 20 defaults or fewer.

Supervisory slotting criteria for specialised lending

4.6.33 G The *FCA* expects a *firm* to assign *exposures* to the risk weight category for specialised lending *exposures* based on the criteria set out in the tables in IFPRU 4 Annex 1G(Slotting criteria).

4.7 Internal ratings based approach: loss given default

Negative LGDs

4.7.1 G The *FCA* expects a *firm* to ensure that no LGD estimate is less than zero.

Low LGDs

4.7.2 G The *FCA* does not expect a *firm* to be using zero LGD estimates in cases other than where it had cash collateral supporting the *exposures*.

4.7.3 G The *FCA* expects a *firm* to justify any low LGD estimates using analysis on volatility of sources of recovery, notably on collateral, and cures (see IFPRU 4.7.5 G). This includes:

(1) recognising that the impact of collateral volatility on low LGDs is asymmetric, as surpluses over amounts owed need to be returned to borrowers and that this effect may be more pronounced when estimating downturn, rather than normal period LGDs; and

(2) recognising the costs and discount rate associated with realisations and the requirements of article 181(1)(e) of the *EU CRR*.

4.7.4 G To ensure that the impact of collateral volatility is taken into account, the *FCA* expects a *firm's* LGD framework to include non-zero LGD floors which are not solely related to administration costs (see article 179(1)(f) of the *EU CRR*).

Treatment of cures

4.7.5 G Where a *firm* wishes to include cures in its LGD estimates, the *FCA* expects it to do this on a cautious basis, with reference to both its current experience and how this is expected to change in downturn conditions. In particular, this involves being able to articulate clearly both the precise course of events that will allow such cures to take place and any consequences of such actions for other elements of its risk quantification. For example:

(1) where cures are driven by the *firm's* own policies, the *FCA* expects the *firm* to consider whether this is likely to result in longer realisation periods and larger forced sale discounts for those *exposures* that do not cure, and higher default rates on the book as a whole, relative to those that might be expected to result from a less accommodating

attitude. To the extent feasible, the *FCA* expects cure assumptions in a downturn to be supported by relevant historical data;

(2) the *FCA* expects a *firm* to be aware of, and properly account for, the link between cures and subsequent defaults. In particular, an earlier cure definition is, other things being equal, likely to result in a higher level of subsequent defaults.

[**Note**: article 5(2) of the *EU CRR*]

4

Incomplete workouts

4.7.6 G To ensure that estimates of LGDs take into account the most up-to-date experience, the *FCA* expects a *firm* to take account of data for relevant incomplete workouts (ie, defaulted *exposures* for which the recovery process is still in progress, with the result that the final realised losses in respect of those *exposures* are not yet certain) (see article 179(1)(c) of the *EU CRR*).

LGD: sovereign floor

4.7.7 G To ensure that sovereign LGD models are sufficiently conservative in view of the estimation error that may arise from the lack of data on losses to sovereigns, the *FCA* expects a *firm* to apply a 45% LGD floor to each unsecured *exposure* in the sovereign asset class (see article 179(1)(a) of the *EU CRR*).

LGD: UK retail mortgage property sales reference point

4.7.8 G The *FCA* believes that an average reduction in property sales prices of 40% from their peak price, prior to the market downturn, forms an appropriate reference point when assessing downturn LGD for *UK* mortgage portfolios. This reduction captures both a fall in the value of the property due to house price deflation, as well as a distressed forced sale discount.

4.7.9 G Where a *firm* adjusts assumed house price values within its LGD models to take account of current market conditions (for example, appropriate house price indices), the *FCA* recognises that realised falls in market values may be captured automatically. A *firm* adopting such approaches may remove observed house price falls from its downturn house price adjustment so as not to double count. A *firm* wishing to apply such an approach must seek the consent of the *FCA* and be able to demonstrate that the following criteria are met:

(1) the adjustment applied to the market value decline element of a *firm*'s LGD model is explicitly derived from the decrease in indexed property prices (ie, the process is formulaic, not judgemental);

(2) the output from the adjusted model has been assessed against the 40% peak-to-trough property sales prices decrease reference point (after inclusion of a forced sale discount);

(3) a minimum 5% market value decline applies at all times in the LGD model; and

(4) the *firm* has set a level for reassessment of the property market price decline from its peak. For example, if a *firm* had initially assumed a peak-to-trough market decline of 15%, then it will have set a level of market value decline where this assumption will be reassessed (see article 181(1)(b) of the *EU CRR*).

Downturn LGDs

4.7.10 G To ensure that its LGD estimates are oriented towards downturn conditions, the *FCA* expects a *firm* to have a process through which it:

(1) identifies appropriate downturn conditions for each IRB *exposure* class within each jurisdiction;

(2) identifies adverse dependencies, if any, between default rates and recovery rates; and

(3) incorporates adverse dependencies, if identified, between default rates and recovery rates in the *firm's* estimates of LGD in a manner that meets the requirements relating to an economic downturn (see article 181(1)(b) of the *EU CRR*).

Discounting cashflows

4.7.11 G To ensure that its LGD estimates incorporate material discount effects, the *FCA* expects a *firm's* methods for discounting cash flows to take account of the uncertainties associated with the receipt of recoveries for a defaulted *exposure*. For example, by adjusting cash flows to certainty-equivalents or by using a discount rate that embodies an appropriate risk premium; or by a combination of the two.

4.7.12 G If a *firm* intends to use a discount rate that does not take full account of the uncertainty in recoveries, the *FCA* expects it to be able to explain how it has otherwise taken into account that uncertainty for the purposes of calculating LGDs. This can be addressed by adjusting cash flows to certainty-equivalents or by using a discount rate that embodies an appropriate risk premium for defaulted assets, or by a combination of the two (see article 5(2) of the *EU CRR*).

Wholesale LGD

4.7.13 G The *FCA* expects a *firm* using advanced IRB approaches to have done the following in respect of wholesale LGD estimates:

(1) applied LGD estimates at transaction level;

(2) ensured that all LGD estimates (both downturn and non-downturn) are cautious, conservative and justifiable, given the paucity of observations. Under article 179(1)(a) of the *EU CRR*, estimates must be derived using both historical experience and empirical evidence, and not be based purely on judgemental consideration. The *FCA* expects the justification as to why the *firm* thinks the estimates are conservative to be documented;

(3) identified and explained at a granular level how each estimate has been derived. This should include an explanation of how internal data, external data, expert judgement or a combination of these has been used to produce the estimate;

(4) clearly documented the process for determining and reviewing estimates, and the parties involved in this process in cases where expert judgement has been used;

(5) demonstrated an understanding of the impact of the economic cycle on collateral values and be able to use that understanding in deriving their downturn LGD estimates;

(6) demonstrated sufficient understanding of any external benchmarks used and identified the extent of their relevance and suitability to the extent that the *firm* can satisfy itself that they are fit for purpose;

(7) evidenced that it is aware of any weaknesses in its estimation process and have set standards, for example related to accuracy, that their estimates are designed to meet;

(8) demonstrated that it has sought and utilised relevant and appropriate external data, including through identifying all relevant drivers of LGD and how these will be affected by a downturn;

(9) ensured, in most cases, estimates incorporate effective discrimination on the basis of at least security-type and geography. In cases where these drivers are not incorporated into LGD estimates, the *FCA* expects the *firm* to be able to demonstrate why they are not relevant;

(10) have an ongoing data collection framework to collect all relevant internal loss and *exposure* data required for estimating LGD and a framework to start using these data as soon as any meaningful information becomes available;

(11) ensure it can articulate the data the *firm* intends to use from any industry-wide data collection exercises that it is participating in, and how the data will be used.

4.7.14 G The *FCA* uses a framework for assessing the conservatism of a *firm*'s wholesale LGD models for which there are a low number of defaults. This framework is set out in IFPRU 4 Annex 2G (Wholesale LGD and EAD framework) and does not apply to sovereign LGD estimates which are floored at 45%. This framework is also in the process of being used to assess the calibration of a *firm*'s material LGD-models for low-default portfolios.

4.7.15 G In the following cases, the *FCA* expects a *firm* to determine the effect of applying the framework in IFPRU 4 Annex 2G (Wholesale LGD and EAD framework) to models which include LGD values that are based on fewer than 20 'relevant' data points (as defined in IFPRU 4 Annex 2G):

(1) the model is identified for review by the *FCA*; or

(2) the *firm* submits a request for approval for a material change to its LGD model.

Unexpected loss on defaulted assets

4.7.16 G The *FCA* considers that both of the following approaches in relation to calculating unexpected loss of defaulted assets are acceptable in principle:

(1) the independent calculation approach; and

(2) subtraction of the best estimate of expected loss from post-default LGD.

4.7.17 G Where an independent calculation approach is adopted for the calculation of unexpected loss on defaulted assets, the *FCA* expects a *firm* to ensure that estimates are at least equal, at a portfolio level, to a 100% risk weight, ie, 8% capital requirement on the amount outstanding net of provisions (see article 181(1)(h) of the *EU CRR*).

Unsecured LGDs where the borrowers' assets are substantially collateralised

4.7.18 G The extent to which a borrower's assets are already given as collateral will clearly affect the recoveries available to unsecured creditors. If the degree to which assets are pledged is substantial, this will be a material driver of LGDs on such *exposures*. Although potentially present in all transactions, the *FCA* expects a *firm* to be particularly aware of this driver in situations in which borrowing on a secured basis is the normal form of financing, leaving relatively few assets available for the unsecured debt. Specialist lending (including property), hedge fund, and some SME/mid-market lending can be considered such cases.

4.7.19 G The *FCA* expects a *firm* to take into account the effect of assets being substantially used as collateral for other obligations estimating LGDs for borrowers for which this is the case. The *FCA* expects a *firm* not to use unadjusted data sets that ignore this impact, and note that it is an estimate for downturn conditions that is normally required. In the absence of relevant data to estimate this effect, conservative LGDs potentially of 100% are expected to be used (see articles 171(2) and 179(1)(a) of the *EU CRR*).

4

4.8 Internal ratings based approach: own estimates of exposure at default (EAD)

Estimation of EAD in place of conversion factors

4.8.1 G The *FCA* considers that a *firm* may provide own estimates of *exposure* at default (EAD) in place of the own estimates of conversion factors (CFs) that it is permitted or required to provide under article 151 of the *EU CRR*.

4.8.2 G For the purpose of this section, references to EAD refer to both direct estimates of EAD and CFs, unless specified otherwise (see article 151 of the *EU CRR*).

General expectations for estimating EAD

4.8.3 G The *FCA* expects that EAD estimates should not be less than current drawings (including interest accrued to date). Consequently, CF estimates should not be less than zero.

4.8.4 G The EAD required for IRB purposes is the *exposure* expected to be outstanding under a borrower's current facilities should it go into default in the next year, assuming that economic downturn conditions occur in the next year and a *firm*'s policies and practices for controlling *exposures* remain unchanged other than changes that result for the economic downturn conditions.

4.8.5 G To achieve sufficient coverage of the EAD, the *FCA* expects *firms* to take into account all facility types that may result in an *exposure* when an obligor defaults, including uncommitted facilities.

4.8.6 G To the extent that a *firm* makes available multiple facilities, the *FCA* expects the *firm* to be able to demonstrate:

(1) how they deal with the fact that *exposures* on one facility may become *exposures* under another on which the losses are ultimately incurred; and

(2) the impact of its approach on its *own funds requirements*.

4.8.7 G The *FCA* expects *firms* using own estimates of EAD to have done the following in respect of EAD estimates:

(1) applied EAD estimates at the level of the individual facility;

(2) where there is a paucity of observations, ensured that all EAD estimates are cautious, conservative and justifiable. In accordance with article 179(1)(a) of the *EU CRR*, estimates must be derived using both historical experience and empirical evidence, and must not be based purely on judgemental consideration. The *FCA* expects the justification as to why the *firm* thinks the estimates are conservative to be documented;

(3) identified and explained at a granular level how each estimate has been derived. This should include an explanation of how internal data, any external data, expert judgement or a combination of these has been used to produce the estimate;

(4) ensured that where expert judgement has been used there is clear communication of the process for arriving at and reviewing the estimates, and identifying the parties involved;

(5) demonstrated an understanding of the impact of the economic cycle on exposure values and be able to use that understanding in deriving downturn EAD estimates;

(6) demonstrated sufficient understanding of any external benchmarks used and identified the extent of their relevance and suitability to the extent that the *firm* can satisfy itself that they are fit for purpose;

(7) evidenced that they are aware of any weaknesses in their estimation process and have set standards that their estimates are designed to meet (eg, related to accuracy);

(8) ensured, in most cases, that estimates incorporate effective discrimination on the basis of at least product features and customer type. In cases where these drivers are not incorporated into EAD estimates, the *FCA* expects the *firm* to be able to demonstrate why they are not relevant;

(9) have an ongoing data collection framework to collect all relevant internal *exposure* data required for estimating EAD and a framework to start using this data as soon as any meaningful information becomes available;

(10) made use of the data they are collecting to identify all relevant drivers of EAD and to understand how these drivers will be affected by a downturn; and

(11) identified dependencies between default rates and conversion factors for various products and markets when estimating downturn EADs. *Firms* are expected to consider how they expect their own policies regarding exposure management to evolve in a downturn.

4.8.8 G The *FCA* uses a framework for assessing the conservatism of *firms*' wholesale EAD models for which there are a low number of defaults. This framework is set out in IFPRU 4 Annex 2G (Wholesale LGD and EAD framework). This

4

framework is in the process of being used to assess the calibration of *firms*' material EAD models for low-default portfolios.

4.8.9 G In the following cases, the *FCA* expects *firms* to determine the effect of applying the framework in IFPRU 4 Annex 2G (Wholesale LGD and EAD framework) to models which include EAD values that are based on fewer than 20 'relevant' data points (as defined in IFPRU 4 Annex 2G):

(1) the model is identified for review by the *FCA*; or

(2) the *firm* submits a request for approval for a material change to its EAD model.

Time horizon

4.8.10 G The *FCA* expects *firms* to use a time horizon of one year for EAD estimates, unless they can demonstrate that another period would be more conservative.

4.8.11 G EAD estimates can be undertaken on the basis that default occurs at any time during the time horizon (the 'cohort approach') or at the end of the time horizon (the 'fixed-horizon approach'). The *FCA* considers that either approach is acceptable in principle.

4.8.12 G The *FCA* expects the time horizon for additional drawings to be the same as the time horizon for defaults. This means that EAD estimation need cover only additional drawings that might take place in the next year, such that:

(1) no *own funds requirements* need be held against facilities, or proportions of facilities that cannot be drawn down within the next year; and

(2) where facilities can be drawn down within the next year, *firms* may, in principle, reduce their estimates to the extent that they can demonstrate that they are able and willing, based on a combination of empirical evidence, current policies, and documentary protection to prevent further drawings (see article 182 of the *EU CRR*).

Direct estimates of EAD

4.8.13 G There are a range of approaches that focus on the total amount that will be drawn down at the time of default and directly estimate EAD. Typically, but not in all cases, these will estimate EAD as a percentage of total limit. These approaches can be described collectively as 'momentum' approaches.

4.8.14 G A 'momentum' approach can be used either:

(1) by using the drawings/limit percentage to formulaically derive a conversion factor on the undrawn portion of the limit; or

(2) by using the higher of percentage of the limit and the current balance as the EAD.

4.8.15 G The *FCA* considers that the use of momentum approaches in both of the ways outlined above is acceptable in principle as an alternative to direct estimation of conversion factors (see article 4(56) of the *EU CRR*).

Distortions to conversion factor estimates caused by low undrawn limits

4.8.16 G In cases where *firms* estimate conversion factors (CFs) directly using a reference data set that includes a significant number of high CFs as a result of very low undrawn limits at the observation date, the *FCA* expects *firms* to:

(1) investigate the distribution of realised CFs in the reference data set;

(2) base the estimated CF on an appropriate point along that distribution, that results in the choice of a CF appropriate for the *exposures* to which it is being applied and consistent with the requirement in article 179 of the *EU CRR* for estimates to include a margin of conservatism related to errors; and

(3) be cognisant that, while the median of the distribution might be a starting point, they should not assume without analysis that the median represents a reasonable unbiased estimate. The *FCA* expects *firms* to consider whether the pattern of distribution in realised CFs means that some further segmentation is needed (eg, treating facilities that are close to full utilisations differently) (see article 182(1)(a) of the *EU CRR*).

Identification of exposures for which an EAD must be estimated

4.8.17 G The *FCA* expects *firms* to treat a facility as an *exposure* from the earliest date at which a customer is able to make drawings under it.

4.8.18 G Where the facility is of the type that it is customary not to advise the borrower of its availability, the *FCA* expects an EAD/CF to be applied from the time that the existence of the facility is recorded on the *firm*'s systems in a way that would allow the borrower to make a drawing.

4.8.19 G If the availability of a facility is subject to a further credit assessment by the *firm*, an EAD/CF may not be required. However, the *FCA* expects this to be the case only if the subsequent credit assessment was of substantially equivalent rigour to that of the initial credit approval and if this includes a re-rating or a confirmation of the rating of the borrower.

4.8.20 G *Firms* are not expected to include in their EAD/CF estimates the probability of increases in limits between observation and default date. If the reference data set includes the impact of such increases, the *FCA* expects *firms* to be able to adjust their estimates accordingly with the aim of assessing what the *exposure* would have been at default if the limit had not been increased.

4.8.21 G The *FCA* expects *firms* to investigate the incidence of *exposures* existing at default that arise from products or relationships that are not intended to result in a credit exposure and, consequently, have no credit limit established against them and are not reflected in their estimates of EAD. Unless such *exposures* are immaterial, the *FCA* expects *firms* to estimate a Pillar 1 *own funds requirement* on a portfolio basis to such *exposures*.

4.8.22 G The *FCA* expects *firms* to investigate how their EAD estimates are impacted by exposures that are in excess of limits at either the observation date (if in the reference data set) or at the current reporting date (for the existing book to which estimates need to be applied). Unless a momentum approach is being used, exposures in excess of limit should be excluded from the reference data set (as the undrawn limit is negative and nonsensical answers would result from their inclusion). The *FCA* expects *firms* to ensure that their EAD estimation includes the risk of further drawings on accounts that are in excess of their limits (see article 4(56) of the *EU CRR*).

Accrued interest

4.8.23 G *Exposures* include not only principal amounts borrowed under facilities but also interest accrued which will fluctuate between payment dates. To ensure proper coverage of interest, the *FCA* expects *firms* to take the following approach:

(1) accrued interest to date should be included in current *exposure* for performing *exposures*;

(2) *firms* may choose whether estimated increases in accrued interest up to the time of default should be included in LGD or EAD;

(3) in the estimation of EAD, increases in accrued interest may be offset against reductions in other outstandings;

(4) estimation of changes in accrued interest needs to take account of changes in the contractual interest rate over the time horizon up to default and in a way consistent with the scenario envisaged in the calculation of the downturn/default weighted average;

(5) inclusion of estimates of future post-default interest is not necessary in either EAD or LGD; and

(6) *firms*' accounting policies will determine the extent to which interest accrued to date is reflected in current exposure as opposed to LGD for defaulted *exposures* (see article 166(1) of the *EU CRR*).

Netting

4.8.24 G The *FCA* considers that there is scope within the *EU CRR* for a *firm* to recognise on-balance sheet netting (including in respect of cross-currency balances) through EAD as an alternative to LGD in cases where a *firm* meets the general conditions for on-balancesheet netting, as set out in article 205 of the *EU CRR*.

4.8.25 G For the CF on undrawn limits, this may be applied on the basis of the net limit, provided the conditions in the *EU CRR* for the use of net limits are met. However, *firms* are reminded that the purpose of the measure is to estimate the amount that would be outstanding in the event of a default. This implies that their ability, in practice, to constrain the drawdown of credit balances will be particularly tested. Moreover, the *FCA* expects the appropriate conversion factor to be higher as a percentage of a net limit than of a gross limit.

4.8.26 G The lower the net limit as a percentage of gross limits or *exposures*, the greater will be the need on the part of the *firm* to ensure that it is restricting *exposures* below net limits in practice and that it will be able to continue to do so should borrowers encounter difficulties. The application of a zero net limit is acceptable in principle but there is, consequently, a very high obligation on the *firm* to ensure that breaches of this are not tolerated (see article 166(3) of the *EU CRR*).

Underwriting commitments

4.8.27 G Estimation of CFs on underwritten facilities in the course of primary market syndication may take account of anticipated sell down to other parties.

4.8.28 G *Firms* are reminded that, since the basis of EAD estimation is that default by the borrower is expected to take place in a one-year time horizon and quite possibly in downturn conditions, the *FCA* expects any reduction in their CF in anticipation of syndication to take account of this scenario (see article 4(56) of the *EU CRR*).

4

4.9 Stress tests

Stress tests used in assessment of capital adequacy

4.9.1 G To be satisfied that the credit risk stress test undertaken by a *firm* under article 177(2) of the *EU CRR* is meaningful and considers the effects of severe, but plausible, recession scenarios, the *FCA* would expect the stress test to be based on an economic cycle that is consistent with IFPRU 2.2.73G(1)(b) (see article 177(2) of the *EU CRR*)

4.10 Validation

4.10.1 G The *FCA* expects a *firm* to have a validation process that includes the following:

(1) standards of objectivity, accuracy, stability and conservatism that it designs its ratings systems to meet and processes that establish whether its rating systems meet those standards;

(2) standards of accuracy of calibration (ie, whether outcomes are consistent with estimates) and discriminative power (ie, the ability to rank-order risk) that it designs its rating systems to meet and processes that establish whether its rating systems meet those standards;

(3) policies and standards that specify the actions to be taken when a rating system fails to meet its specified standards of accuracy and discriminative power;

(4) a mix of developmental evidence, benchmarking and process verification and policies on how this mixture varies between different rating systems;

(5) use of both quantitative and qualitative techniques;

(6) policies on how validation procedures are expected to vary over time; and

(7) ensuring independent input into, and review of, its rating systems (see article 188 of the *EU CRR*).

4.10.2 G In IFPRU 4.10.1 G:

(1) developmental evidence means evidence that substantiates whether the logic and quality of a rating system (including the quantification process) adequately discriminates between different levels of, and delivers accurate estimates of, PD, EL, LGD and conversion factors (as applicable); and

(2) process verification means the process of establishing whether the methods used in a rating system to discriminate between different levels of risk and to quantify PD, EL, LGD and conversion factors are being used, monitored and updated in the way intended in the design of the rating system (see article 188 of the *EU CRR*).

4

4.10.3 G The *FCA* expects a *firm* to be able to explain the performance of its rating systems against its chosen measure (or measures) of discriminative power. In making this comparison, a *firm* should rely primarily on actual historic default experience where this is available. In particular, the *FCA* expects a *firm* to be able to explain the extent of any potential inaccuracy in these measures, caused, in particular, by small sample size and the potential for divergence in the future, whether caused by changing economic conditions or other factors. *Firms*' assessment of discriminative power should include appropriate use of external benchmarks where available.

4.10.4 G The *FCA* will take into consideration the sophistication of the measure of discrimination chosen when assessing the adequacy of a rating system's performance.

4.10.5 G In the case of a portfolio for which there is insufficient default experience to provide any confidence in statistical measures of discriminative power, the *FCA* expects a *firm* to use other methods. For example, analysis of whether the *firm*'s rating systems and an external measurement approach (eg, external ratings) rank common obligors in broadly similar ways. Where such an approach is used, the *FCA* would expect a *firm* to ensure it does not systematically adjust its individual ratings with the objective of making them closer to the external ratings as this would be counter to the philosophy of an internal rating approach. The *FCA* expects a *firm* to be able to explain the methodology it uses and the rationale for its use.

4.11 Income-producing real estate portfolios

Compliance with EU CRR

4.11.1 G The *FCA* considers that income-producing real estate (IPRE) is a particularly difficult asset class for which to build effective rating systems that are compliant with the requirements of the internal ratings based (IRB) approach.

4.11.2 G As with all asset classes, *firms* should assess whether their IPRE model is *EU CRR* compliant and not whether it is the nearest they can get to compliance given the constraints imposed on their model development (eg, lack of data or resource constraints).

4.11.3 G Where material non-compliance is identified and cannot be remediated in a timely fashion, *firms* should adopt a compliant approach for calculating *own funds requirements*. In most cases, this is likely to be the slotting approach (see article 144(1) of the *EU CRR*).

Drivers of risk

4.11.4 G *Firms* should be able to demonstrate that the model drivers selected offer sufficient discriminatory power and to justify why other potential data sources are not expected to materially improve the discriminatory power and accuracy of estimates.

4.11.5 G The *FCA* expects that an IPRE rating system will only be compliant if a *firm* is able to demonstrate the following in respect of its treatment of cash flows (except where the *firm* can demonstrate that this is not an appropriate risk driver):

(1) the difference in deal ratings when tenant ratings are altered is intuitive;

(2) the transformation of ratings into non-rent payment probability is intuitive. Even where tenants are rated by the *firm* the PD will not usually represent a direct read across to probability of non-payment due to, for example, model philosophy issues. Addressing this is likely to be a key area since many *firms* struggle with defining what divergence is expected between observed default rate and PD in different economic conditions in the mid corporate space;

(3) the selection of parameter values and/or distributions, and their impact on deal ratings, is well supported and intuitive;

(4) the impact on the deal rating is intuitive for such features as type of building, geographical location and building quality; and

(5) where data are missing or unavailable the treatment is conservative.

4

4.11.6 G The *FCA* expects that an IPRE rating system will only be compliant if a *firm* is able to demonstrate the following in respect of its treatment of interest-rate risk (IRR):

(1) IRR is included as a relevant risk driver (unless the portfolio is exclusively hedged);

(2) the way in which IRR is included in the deal rating is intuitive with respect to model philosophy. For example, a 'point in time' rating should consider the current interest rate and likely change over a one-year time horizon, whereas a 'through-the-cycle' model needs to consider the IRR averaged over an economic cycle; and

(3) the model rates deals where IRR is hedged by the *firm* differently from deals where IRR is unhedged and the magnitude of the difference in these ratings is intuitive.

4.11.7 G The *FCA* expects that an IPRE rating system will only be compliant if a *firm* is able to demonstrate the following in respect of its treatment of refinance risk:

(1) refinance risk is included as a relevant risk driver (unless the portfolio contains only amortising loans);

(2) the model rates interest only and amortising deals differently in the final year and that the magnitude of the difference in these ratings is intuitive;

(3) given the time horizon associated with IRB estimates (ie 12 months), the refinance risk could have a zero weight until the deal enters its final year for point-in-time models. In these cases, the risk should be captured in stress testing and Pillar 2; and

(4) the *firm* is able to report by borrowers that have previously had a distressed restructuring unlikeliness to pay indicator (even if they are now performing) by number, EAD and risk weighted exposure amounts.

Calibration

4.11.8 G The *FCA* expects that *firms* will not be compliant with the calibration requirements relating to use of a long-run default rate, unless it can demonstrate that:

(1) the internal data series is the longest relevant and accurate data series, on a *EU CRR* compliant definition of default, that is available;

(2) the determination of long-run default rate includes reference to an appropriate source of downturn data (this may require the use of external data);

(3) the relevance of any external data used is analysed, and the relationship between internal default data and the external data used is considered over a multi-year period; and

(4) where uncertainty is introduced due to, for example, the quality of internal data or shortcomings in the relevance of external data, a conservative adjustment to the estimates should be made.

4.11.9 G The *FCA* expects that a *firm* will only be compliant with the calibration requirements relating to model philosophy if it can demonstrate that:

(1) the model philosophy is clearly articulated and justified. Justification should include analysis of the performance of assets, and the corresponding ratings assigned, over a change in economic conditions (ie, as long as period as possible); and

(2) in addition to encapsulating this information in a coherent way in the calibration, the impact of capturing risks such as IRR and refinance risk is clearly documented.

Low default portfolios

4.11.10 G Where the rating system is classed as a low default portfolio in accordance with the *guidance* in this section, a *firm* should be able to demonstrate that the framework applied adequately considers:

(1) economic environment of data used;

(2) changes in portfolio composition over time;

(3) parameter choices; and

(4) model philosophy.

Constructed theoretically

4.11.11 G Under article 144(1) of the *EU CRR*, all models, including those constructed from a theoretical basis without reference to any empirical default data (such as Monte-Carlo cash-flow simulation models), must meet the IRB requirements that are set out in Title II Chapter 3 of Part Three of the *EU CRR* (IRB approach).

4.11.12 G The *FCA* considers that, to meet the requirements referred to in IFPRU 4.11.1 G, it will be necessary for *firms* to demonstrate that a *firm* has a good understanding of PD models that are constructed theoretically and that the parameter estimates reflect a one-year PD. In addition, even if empirical data were not used to determine the PD estimate it should, where available, be used to back-test the estimates.

4.11.13 G The *FCA* expects that, as most models of this type will be able to produce one-year estimates of PD that correspond closely to point-in-time estimates, *firms* should conduct robust back-testing of such estimates by comparing them with realised default rates. *Firms* would need to demonstrate that the results of such back-testing meet pre-defined and stringent standards in order for the *FCA* to be satisfied that the IRB requirements are met.

4.11.14 G Because assumptions in the model build process are likely to materially impact the resulting PDs, the *FCA* would expect these choices to be clearly justified in the model documentation and to have been independently reviewed. To be satisfied that a *firm* is complying with article 176(1)(d) of the *EU CRR*, the *FCA* expects a *firm* to support justification for all assumptions with analysis of the sensitivity of the model outputs to changes in the assumptions.

4.11.15 G Where the *firm* has fewerthan 20 defaults in their internal data set, the *FCA* expects it to be necessary for *firms* to perform a statistical low default portfolio calibration, as set out in the *guidance* in this section.

Validation

4.11.16 G The *FCA* expects that a *firm* will be compliant with the validation requirements only whereit can demonstrate, in respect of discriminatory power, that:

(1) appropriate minimum standards that the rating system is expected to reach are defined, together with reasoning behind the adoption of such standards and that the factors considered when determining the tests are clearly documented;

(2) an objective rank-ordering metric, measured using an appropriate time horizon (eg, using ratings one year prior to default) or cohort approach, such as Gini or Accuracy Ratio of 50% is achieved over time;

(3) where there are sufficient defaults from different time periods the discriminatory power is shown to have reached the appropriate minimum standard over an extended time period (ie, longest period possible, including most recent data); and

(4) any concentrations in ratings from the model are demonstrated to be appropriate.

4.11.17 G The *FCA* expects that a *firm* will be compliant with the validation requirements only whereit can demonstrate in respect of the calibration that:

(1) observed default rate versus PD is considered at grade level and across a range of economic environments (ie, as long as period as possible);

(2) where the PD does not relate to a pure point-in-time estimate, either the PD or the observed default rate is transformed such that comparison between the two is meaningful. This transformation

should be consistent with the model philosophy and calibration technique applied; and

(3) pre-defined tolerances for the degree of divergence, and the associated actions for what should happen when they are not met, are set.

4.11.18 G The *FCA* also expects that a *firm* will be compliant with the validation requirements only whereit can demonstrate that:

(1) appropriate stability metrics should be considered across a range of economic environments (ie, longest period possible including most recent data);

(2) the tolerances for the degree of divergence, and associated actions for what should happen when they are not met, is pre-defined; and

(3) subsections of portfolios by characteristics affecting risk profile, and therefore potentially model performance, are investigated. Such subsections could include:

(a) loan type (amortising/interest only);

(b) degree of hedging;

(c) building type; and

(d) other factors such as non-SPV (special purpose vehicle) lending in a predominately SPV lending book or vice versa (see article 188 of the *EU CRR*).

Other requirements

4.11.19 G The *FCA* expects that a *firm* will be able to comply with certain other *EU CRR* requirements only where it candemonstrate that:

(1) in relation to article 144(1)(e) of the *EU CRR*, where more than one model is used, the rationale, and the associated boundary issues, is clearly articulated and justified and the criteria for assigning an asset to a rating model are objective and clear;

(2) in relation to article 173(1)(c) of the *EU CRR*, the *firm* has a process in place to ensure valuations of the property are appropriate and up to date;

(3) in relation to article 171(2) of the *EU CRR*, the *firm* makes reference to information available from the Investment Property Databank where relevant. Where this data is utilised at a broad level when more granular data is available this is fully justified with appropriate analysis;

(4) in relation to article 173(1)(b) of the *EU CRR*, the rating histories demonstrate that deals are re-rated every time material information becomes available, for example where the deal enters its final year (and refinance risk becomes relevant) or a tenant defaults, is replaced or has their rating changed;

(5) in relation to article 189(3) of the *EU CRR*, management information covering all aspects required by the *EU CRR* is produced and reviewed regularly by *senior management* and the tolerances for the degree of divergence, and associated actions for what should happen when they are not met, are pre-defined; and

(6) in relation to article 177(2) of the *EU CRR*, the impact on PDs and risk-weighted exposure amounts in a *firm*'s credit risk stress test is consistent with model philosophy (although ratings should be affected by events such as tenant defaults even if they are TTC) and impairment projections are justified with reference to past internal data.

4.12 Securitisation

Recognition of significant risk transfer

4.12.1 R (1) A *firm* must notify the *FCA* that it is relying on the deemed transfer of significant credit risk under article 244(2) of the *EU CRR* (Traditional securitisation) or article 245(2) of the *EU CRR* (Synthetic securitisation), including when this is for the purposes of article 337(5) of the *EU CRR*, no later than one month after the date of the transfer.

(2) The notification in (1) must include sufficient information to allow the *FCA* to assess whether the possible reduction in risk-weighted exposure amounts which would be achieved by the *securitisation* is justified by a commensurate transfer of credit risk to third parties.

Significant risk transfer notifications and permissions

4.12.2 G An *originator* of *securitisations* is able to use the *securitisation* risk weights (and not calculate *own funds requirements* on the assets underlying its *securitisation*) in either of the following cases:

(1) the *firm* transfers significant credit risk associated with the *securitised exposures* to third parties; or

(2) the *firm* deducts from *common equity tier 1 capital* or applies a 1250% risk weight to all positions it holds in the *securitisation*.

4.12.3 G The significant risk transfer requirements in articles 244 (Traditional securitisation) or 245 (Synthetic securitisation) of the *EU CRR* provide three options for a *firm* to demonstrate how it transfers significant credit risk for any given transaction:

(1) the *originator* does not retain more than 50% of the risk-weighted exposure amounts of mezzanine *securitisation positions* (as defined in article 242(18) of the *EU CRR*), where these are:

(a) *securitisation positions* to which a risk weight lower than 1250% and higher than 25% applies in accordance with Sub-Sections 2 and 3 of Section 3 of Chapter 5 (Securitisation) of the *EU CRR*; and

(b) subordinated to the senior *securitisation position* and more senior than the first loss tranche;

(2) where there is no mezzanine position, the *originator* does not hold more than 20% of the *exposure* values of *securitisation positions* that

are subject to a deduction or 1250% risk weight and where the *originator* can demonstrate that the *exposure* value of such *securitisation positions* exceeds a reasoned estimate of the expected loss on the *securitised exposures* by a substantial margin; and

(3) the *competent authority* may grant permission to an *originator* to make its own assessment if it is satisfied that the *originator* can meet certain requirements.

Significant risk transfer under options 1 and 2

4.12.4 G IFPRU 4.12.1 R requires a *firm* to notify the *FCA* of each transaction on which it seeks capital relief under the options in IFPRU 4.12.3 G (1) (option 1) and (2) (option 2).

4.12.5 G Where the *FCA* considers that the possible reduction in risk-weighted exposure amounts (RWEA) achieved via the *securitisation* is not justified by a commensurate transfer of credit risk to third parties, significant risk transfer will be considered to not have been achieved. Consequently, a *firm* will not be able to recognise any reduction in RWEA due to the transaction.

Option 3

4.12.6 G For IFPRU 4.12.3 G (3) (option 3), the *FCA* intends to grant permission for an *originator* to make its own assessment of significant risk transfer only where it is satisfied that:

(1) in every relevant case, the reduction in *own funds requirements* achieved would be justified by a commensurate transfer of risk to third parties;

(2) the *firm* has adequate internal risk management policies and methodologies to assess the transfer of risk; and

(3) such transfer of risk to third parties is also recognised for the purposes of the *firm's* internal risk management and internal capital allocation.

4.12.7 G Where the *FCA* grants permission for multiple transactions, then that permission is expected to cover a defined scope of potential transactions. The permission is expected to enable a *firm* (within certain limits) to carry out these transactions without notifying the *FCA* in each individual instance.

Deduction or 1250% risk weighting

4.12.8 G A *firm* seeking to achieve capital relief by deducting or applying a 1250% risk weight where permitted under articles 244 or 245 of the *EU CRR* does not need to make the notification in IFPRU 4.12.1 R. However, in such cases, a *firm* should consider whether the characteristics of the transaction are such that the *FCA* would reasonably expect prior notice of it.

Significant risk transfer notifications

4.12.9 G Under IFPRU 4.12.1 G, within one *month* of a *securitisation* transaction closing, a *firm* must notify the *FCA* of the transaction if it has relied on options 1 or 2 to achieve significant risk transfer.

4.12.10 G Notification under IFPRU 4.12.1 G should include sufficient information to enable the *FCA* to assess whether the possible reduction in RWEA which would be achieved by the *securitisation* is justified by a commensurate transfer of credit risk to third parties. The *FCA* expects this to include the following:

(1) details of the *securitisation positions*, including rating, *exposure* value and RWEA broken down by *securitisation positions* sold and retained;

(2) key transaction documentation and any relevant supporting documents (eg, a summary of the transaction);

(3) details of the governance process for the transaction, including details of any committees involved in approving the transaction;

(4) a copy of the significant risk transfer policy applied to the transaction, including details of the methodology and any models used to assess risk transfer;

(5) a statement of how all relevant risks are incorporated into the significant risk transfer assessment and how the full economic substance of the transaction is taken into consideration;

(6) the significant risk transfer calculation, setting out why the *firm* believes the capital relief proposed is commensurate with the credit risk transferred to third parties;

(7) the *EU CRR* requirements the *firm* is relying on;

(8) copies of investor and internal presentations on the transaction;

(9) the rationale for the transaction;

(10) details of the underlying assets (including asset class, geography, tenor, rating, spread, collateral, *exposure* size);

(11) details of the transaction structure;

(12) description of the risks being retained;

(13) details of the cashflow between parties involved in the transaction;

(14) details of the ratings and pricing of bonds issued in the transaction;

(15) details of any connected parties involved in the transaction;

(16) details of any termination options (for example, call options); and

(17) details of reliance on *ECAIs* in the significant risk transfer assessment.

4

4.12.11 G The *FCA*'s review will focus on the proportion of credit risk transferred, compared to the proportion by which RWEA are reduced in the transaction. Where the *FCA* judges that the reduction in RWEA is not justified by a commensurate transfer of credit risk to third parties, it will inform the *firm* that significant risk transfer has not been achieved by this transaction. Otherwise, the *FCA* will inform the *firm* that it does not object to the transaction.

4.12.12 G The *FCA* does not intend to pre-approve transactions. The *FCA* will provide a view on whether it considers that commensurate risk transfer has been achieved at a point in time, which may be provided after a transaction has closed. The *FCA* may reassess its judgement of the achievement of commensurate risk transfer if the level of credit risk transfer in a transaction changes materially.

Significant risk transfer permissions

4.12.13 G A *firm* may apply for permissions under articles 244 (Traditional securitisation) or 245 (Synthetic securitisation) of the *EU CRR* to consider significant risk transfer to have been achieved without needing to rely on options (1) or (2). The scope of such permission maybe defined to cover a number of transactions or an individual transaction.

Multiple transaction permissions

4.12.14 G Where a *firm* applies for such permission, the *FCA* would expect the scope should be defined according to a range of characteristics, including the type of asset class and the structural features of the transaction. The characteristics the *FCA* would expect a *firm* to consider when scoping a permission application include:

(1) asset class (eg, residential mortgages, commercial mortgages, credit card receivables, leasing, loans to corporates or small and medium-sized enterprises (SMEs), consumer loans, trade receivables, *securitisations*, private finance initiative (PFI), insurance, other assets, covered bonds);

(2) further asset class distinction (eg, geography and asset quality); and

(3) structural features (eg, by distinguishing between securitisation and re-securitisation, traditional and synthetic securitisation and non-revolving structures and revolving structures).

4.12.15 G It is likely for it to be more straightforward for the *FCA* to assess relatively narrowly scoped permissions than those covering a wide range of assets and/or with complex structural features.

Areas of review and information to be submitted for permission

4.12.16 G To assess a *firm*'s ability to use its own policies and methodologies for assessing significant risk transfer, the *FCA*'s permission reviews will focus on:

(1) the *firm*'s understanding of the risk of any potential transactions within permission scope, including for potential underlying assets, *securitisation* structures and other relevant factors that affect the economic substance of risk transfer;

(2) the governance around significant risk transfer assessment (including sign-off procedures) and systems and controls relating to risk-transfer assessment and determination of significant risk transfer;

(3) significant risk transfer calculation policies and methodologies, including any models used;

(4) the *firm*'s historical experience with relevant *securitisation* origination; and

(5) the use of third-party risk assessments (eg, *ECAI* ratings) and the relationship with internal assessments.

4.12.17 G The information the *FCA* expects a *firm* to provide in a permission application includes the following:

(1) details of the *firm*'s governance processes for significant risk transfer, including details of any relevant committees and the seniority and expertise of key persons involved in sign-off;

(2) a copy of the *firm*'s significant risk transfer policy, including details of the significant risk transfer calculation policies, methodologies and any models used to assess risk transfer (this should set out how the *firm* ensures it only takes capital relief in proportion to the amount of risk transferred on any given transaction);

(3) a statement of how all relevant risks are incorporated in the significant risk transfer calculations and how the full economic substance of transactions is taken into consideration;

(4) details of the *firm*'s systems and controls regarding risk transfer in *securitisations*;

(5) a copy of the *firm*'s capital allocation strategy;

(6) details of any *securitised* assets that have come back on the *firm*'s balance sheet and the reason why; and

(7) details of reliance on *ECAIs* in determining significant risk transfer.

Limits attached to multiple transaction permissions: materiality

4.12.18 G The *FCA* intends to apply two materiality limits to the proportion of risk-weighted exposure amount (RWEA) relief that can be taken under any permission covering multiple transactions:

(1) transaction level limit any transaction that would, in principle, be within the scope of the permission, but that resulted in an RWEA reduction exceeding 1% of the *firm*'s credit risk-related RWEAs as at the date of the *firm*'s most recent regulatory return, will fall outside

4

the scope of a multiple transaction permission and will require a separate permission or require notification (if the transaction would satisfy option 1 or 2); and

(2) aggregate limit once the aggregate RWEA reduction taken on all significant risk transfer transactions executed within the scope of a permission exceeds 5% of the *firm*'s credit risk-related RWEAs as at the date of the *firm*'s most recent regulatory return, no additional transactions may be executed within scope of the permission. In such circumstances, a *firm* should take one of the following actions:

(a) reapply to renew the multiple transaction permission; or

(b) apply for a new permission covering the specific transactions exceeding the RWEA limit; or

(c) notify the *FCA* of the transaction, following the significant risk transfer notification procedure (if the transactions would satisfy option 1 or 2).

Limits attached to multiple transaction permissions: duration of permission

4.12.19 G Multiple transaction permissions can be expected to be granted for a period of one year. The *FCA*'s review of permission renewal will focus on any changes to the *firm*'s significant risk transfer policies and methodologies since the previous review.

Individual transaction permission

4.12.20 G Permissions relating to individual transactions do not need to be granted prior to the execution of a transaction. The *FCA* does not intend to specify the timeframe in which a *firm* should submit an individual transaction permission, but the *firm* should note that capital relief from a specific transaction will not be available until a *firm* has obtained permission covering the significant risk transfer assessment and capital treatment (unless the transaction is being notified under option 1 or 2, or falls within scope of a multiple transaction permission).

4.12.21 G The information the *FCA* expects to receive in an individual transaction permission includes that in ■ IFPRU 4.12.10G (2) and ■ IFPRU 4.12.10 G (6) to ■ IFPRU 4.12.10 G (17), as well as that in ■ IFPRU 4.12.17G (1) to ■ (3).

Limits attached to individual transaction permissions

4.12.22 G Depending on the nature of a transaction, the *FCA* may grant an individual permission for the duration of the transaction, or may impose a time limit on the permission. Where a *firm* sought to take capital relief on a transaction beyond the expiry date of the relevant permission, the *firm* would need to renew the permission prior to its expiry date.

4.12.23 G Given that significant risk transfer should be met on a continuing basis, permissions will typically include a requirement to notify the *FCA* of any change in circumstances from those under which the permission was granted (eg, where the amount of credit risk transfer had changed materially). Any reduction in credit risk transfer subsequent to the permission being granted will require the *firm* to take a commensurate reduction in RWEA relief. If a *firm* does not effect a commensurate reduction in the RWEA relief, the *FCA* may revoke the relevant permission.

Regulatory capital calculation methodology and significant risk transfer

4.12.24 G An *originator* must transfer a significant amount of credit risk associated with *securitised exposures* to third parties to be able to apply the *securitisation* risk weights set out in Part Three, Title II, Chapter 5 of the *EU CRR* (Securitisation), and any associated reduction in *own funds requirements* must be matched by a commensurate transfer of risk to third parties.

4.12.25 G As part of the notification and permissions process, the *FCA* expects the *firm* to inform it of the methodology it intends to use to calculate *securitisation* capital requirements.

Implicit support and significant risk transfer

4.12.26 G As part of a *firm*'s ongoing consideration of risk transfer, the *FCA* expects it to consider the support it has provided to *securitisation* transactions.

4.12.27 G

(1) If a *firm* is found to have provided support to a *securitisation*, the expectation that the *firm* will provide future support to its securitisations is increased. The *FCA* will take account of this increased expectation in future assessments of commensurate risk transfer to that firm.

(2) The *FCA* expects *securitisation* documentation to make clear, where applicable, that repurchase of *securitisation positions* by the *originator* beyond its contractual obligations is not mandatory and may only be made at fair market value.

(3) Where a *firm* provides support which it is entitled, but not obliged, to provide under the contractual documentation of the *securitisation*, the *FCA* will consider the following factors in assessing if that support has been appropriately reflected in the assessment of significant risk transfer:

(a) whether the fact that the *firm* may provide such support was expressly set out in the contractual and marketing documents for the *securitisation*;

(b) whether the nature of the support that the *firm* may give is precisely described in the documentation;

(c) whether the maximum degree of support that could be provided could be ascertained at the time of the *securitisation* by the *firm* and by a person whose only information came from the marketing documents for the *securitisation*;

(d) whether the assessment of whether significant risk transfer was achieved and the amount of that risk transferred was made on the basis that the *firm* would provide support to the maximum degree possible; and

(e) whether the *firm's own funds* and *own funds requirements* were appropriately adjusted at the time of the *securitisation* on the basis that the *firm* provided support to the maximum degree possible.

(4) If a *firm* fails to comply with article 250(1) of the *EU CRR*, the *FCA* may require it to disclose publicly that it has provided non-contractual support to the transaction.

4

High-cost credit protection and other significant risk transfer considerations

4.12.28 G Some transactions can transfer little or no economic risk from the protection buyer to the protection seller, but may still result in a reduction in *own funds requirements*. A particular example of a transaction-type of concern involves protection being purchased on a junior tranche and a high premium is paid for that transaction.

4.12.29 G Generally, the amount of premium paid will not materially affect the assessment of whether significant risk transfer has occurred. This is because either:

(1) the protection payment payable upon default from protection seller to protection buyer is significantly larger than the overall premium payable to the protection seller; or

(2) the payment of premium leads to an immediate incurred cost.

4.12.30 G However, there comes a point at which the premium payable for the protection can reduce significantly the actual economic risk that is transferred from the protection buyer to protection seller. A premium payable of 100% of the protection amount could leave the protection buyer in a position over the life of the transaction that was no better than if protection had not been purchased.

4.12.31 G The *FCA* expects *originators* seeking to apply the *securitisation* risk weights to synthetic *securitisations* to take into account all relevant factors to assess the amount of risk transferred. As well as the size and timing of amounts payable to the protection seller, the circumstances in which those amounts are payable can undermine the effectiveness of risk transfer. The *FCA* expects a *firm* seeking capital relief through synthetic securitisations to incorporate premiums in their assessment of significant risk transfer. In particular, the following transaction features may have a significant impact on the amount of risk transfer:

(1) premium which is guaranteed in all or almost all circumstances, for example, premium which is payable upfront or deferred; or

(2) those that could result in the amount of premium payable for protection being significantly greater than the spread income on the assets in the portfolio or similar to the size of the hedged position; or

(3) those under which the protection buyer retains the expected loss through higher transaction costs to the counterparty, in the form of premium or otherwise.

4.12.32 G Article 238 of the *EU CRR* (Maturity of credit protection) requires maturity to be assessed in considering significant risk transfer. When considering the effective maturity of synthetic *securitisations*, the *FCA* expects a *firm* to consider whether the transaction contained an option to terminate the protection at the discretion of the protection buyer.

4.12.33 G The *FCA* considers the following to be examples of features which generally indicate a positive incentive to call or, at least, to constitute grounds for discussion with the *FCA* prior to the conclusion of the transaction:

(1) the transaction contains terms, such as payments at maturity or payments upon early termination or significant premiums, which may reduce risk transfer;

(2) the transaction includes a requirement for the protection buyer to incur additional costs or obligations if they do not exercise their option to terminate the protection; and

(3) there are pre-agreed mechanisms, for example 'at-market unwinds', where the protection seller and protection buyer agree that the transaction can be terminated in the future at a 'market' value and specifies aspects of how the value is calculated.

High-level significant risk transfer considerations

4.12.34 G Significant risk transfer is an ongoing requirement. Accordingly, the *FCA* expects *firms* to ensure that any reduction in *own funds requirements* achieved through *securitisation* continues to be matched by a commensurate transfer of risk throughout the life of the transaction. The *FCA* expects *firms* to take a substance over form approach to assessing significant risk transfer. *Firms* should be able to demonstrate that the capital relief post-transaction adequately captures the economic substance of the entire transaction, and is commensurate to retained risk.

4.12.35 G When risk transfer transactions are structured as a group of linked transactions rather than a single transaction, the *FCA* expects the aggregate effect of linked transactions to comply with the *EU CRR*. The *FCA* expects *firms* to ensure that analysis of risk transfer incorporates all linked transactions, particularly if certain transactions within a group of linked transactions are undertaken at off-market rates.

4.12.36 G The *FCA* expects the instruments used to transfer credit risk not to contain provisions which limit the amount of risk transferred. For example, should losses or defaults on the *securitised exposures* occur(ie, deterioration in the credit quality of the underlying pool) the *FCA* expects the *originator's* net cost of protection or the yield payable to investors should not increase as a result.

4.12.37 G To ensure continued appropriateness, the *FCA* expects *firms* to update the opinions of qualified legal counsel, required by the *EU CRR*, as necessary to ensure their continuing validity. For example, an opinion may need to be updated if relevant statutory provisions are amended, or where a new decision or judgment of a court has a bearing on the continuing validity of counsel's opinion.

4.12.38 G The *FCA* expects relevant *senior management* of a *firm* to be appropriately engaged in the execution of *securitisation* transactions that lead to a reduction in RWEA where the *firm* is providing or purchasing structured trades.

4.12.39 G The *FCA* does not operate a pre-approval process for transactions. The *FCA* expects a *firm* to discuss with its supervisor at any early stage *securitisation* transactions that are material or have complex features. Where a *firm* claims a regulatory capital reduction from *securitisation* transactions in its disclosures to the market, the *FCA* expects such disclosures to include caveats making clear the risk of full or partial re-characterisation where this risk is material in the light of the *FCA's* stated policy.

4.12.40 G Although this section sets out the *FCA's* expectations regarding *securitisations*, these expectations are also relevant for other similar credit protection arrangements.

4.12.41 G The *FCA* will seek to ensure that the *securitisation* framework is not used to undermine or arbitrage other parts of the prudential framework. For other similar credit protection arrangements (eg, those subject *credit risk mitigation* or *trading book* requirements), the impact of certain features (such as significant premiums or call options) may cast doubt on the extent of risk transferred and the resulting capital assessment. Features which result in inadequate *own funds requirements* compared to the risks a *firm* is running may result in the credit protection not being recognised or the *firm* being subject to extra capital charges in their *ICG* in Pillar 2 add-ons. Credit protection arrangements in general are subject to the same overarching principles as those in the *securitisation* framework.

4.12.42 G Where a *firm* achieves significant risk transfer for a particular transaction, the *FCA* expects it to continue to monitor risks related to the transaction to which it may still be exposed. The *firm* should consider capital planning implications of *securitised* assets returning to its balance sheet. The *EU CRR* requires a *firm* to conduct regular stress testing of its *securitisation* activities and off-balance sheet *exposures*. The stress tests should consider the *firm*-wide impact of stressed market conditions on those activities and *exposures* and the implications for other sources of risk (eg, credit risk, concentration risk, counterparty risk, *market risk*, *liquidity risk* and reputational risk). Stress testing of *securitisation* activities should take into account both existing *securitisations* and pipeline transactions. A *firm* should have procedures in place to assess and respond to the results of that stress testing and these should be taken into account under the *overall Pillar 2 rule*.

4.13 Settlement risk

4.13.1 R Where a system wide failure of a settlement system, a clearing system or a *CCP* occurs, the *own funds requirements* calculated in articles 378 (Settlement/delivery risk) and 379 (Free deliveries) of the *EU CRR* are waived until the situation is rectified. In this case, the failure of a counterparty to settle a trade shall not be deemed a default for purposes of credit risk.

[**Note**: article 380 of the *EU CRR*]

4

4.14 Counterparty credit risk

Hedging sets

4.14.1 R For the purpose of article 282(6) of the *EU CRR* (Hedging sets), a *firm* must apply the CCR Mark-to-market method as set out in Part Three, Title II, Chapter 6, Section 3 (Mark-to-market method) of the *EU CRR* to:

(1) transactions with non-linear risk profile; or

(2) *payment legs* and transactions with debt instruments as underlying;

for which it cannot determine the delta or the modified duration, as the case may be, using an internal model approved by the *FCA* under Part Three Title IV of the *EU CRR* for the purposes of determining *own funds requirements* for market risk.

Recognition of netting: interest rate derivatives

4.14.2 R For the purpose of article 298(4) of the *EU CRR* (Effects of recognition of netting as risk-reducing), a *firm* must use the original maturity of the *interest-rate contract*.

4.14.3 G A *firm* may apply to the *FCA* under section 138A of the *Act* to *waive* IFPRU 4.14.2 R if it wishes to use the residual maturity of the *interest-rate contract*.

Use of internal CVA model for calculation of the maturity factor 'M'

4.14.4 G (1) This *guidance* sets out the *FCA's* expectations for granting permission to a *firm* to use its own one-sided credit valuation adjustment internal models (an "internal CVA model") for the purpose of estimating the maturity factor "M", as proposed under article 162(2)(h) of the *EU CRR* (Maturity).

(2) In the context of counterparty credit risk, the maturity factor "M" is intended to increase the *own funds requirements* to reflect potential higher risks associated with medium and long-term OTC derivative portfolios, more specifically when the exposure profile of these contracts is significant beyond one year. This adjustment is only applicable to a *firm* using the Internal Model Method for the calculation of *exposure* values.

(3) A *firm* is permitted to replace the formula for the maturity factor "M", as set out in article 162(2)(g) of the *EU CRR* with the 'effective

credit duration' derived by a *firm's* internal CVA model, subject to permission being granted by the *FCA*, as the *competent authority*.

(4) Internal CVA models are complex by nature and modelling practises vary significantly across the industry. The *FCA* considers the creation of an acceptable model resulting in an appropriate credit duration to be challenging, and so would require extensive review. Accordingly, the *FCA* expects a *firm* to demonstrate a strong case for the granting of such permission.

(5) A *firm* that wishes to make an application under article 162(2)(h) should provide a satisfactory justification for the use of an internal CVA model for estimating the maturity factor "M". The purpose of reducing the *own funds requirements* for counterparty credit risk will not, on its own, be considered as a reasonable justification. The *FCA* will also expect highly conservative modelling assumptions within a *firm's* internal CVA model for the purpose of article 162(2)(h).

Permission to set the maturity factor 'M' to 1 for the counterparty credit risk default charge

4.14.5 G

(1) This *guidance* sets out the *FCA's* expectations for permitting a *firm* with the permission to use the Internal Model Method set out in Part Three, Title II, Chapter 6, Section 6 (Internal model method) and the permission to use an internal VaR model for specific risk set out in Part Three, Title IV, Chapter 5 (Use of internal models) associated with traded debt instruments to set to 1 the maturity factor "M" defined in article 162 of the *EU CRR*.

(2) In the context of counterparty credit risk, the maturity factor "M" is intended to increase the *own funds requirements* to reflect the potential higher risks associated with medium and long-term *OTC derivative* portfolios, more specifically when the exposure profile of these contracts is significant beyond one year. This adjustment is only applicable to *firms* using the Internal Model Method for the calculation of *exposure* values.

(3) Article 162(2)(i) of the *EU CRR* allows a *firm* to set the maturity factor "M" to 1 for a *firm* using the Internal Model Method provided that the *firm's* internal value-at-risk (VaR) model for specific risk associated with traded debt instruments reflects the effect of rating migration and subject to the permission of the *FCA*, as the *competent authority*.

(4) Internal VaR models for specific risk associated with traded debt instruments are not specifically designed to capture the effects of rating migrations. The risk captured by these models is based on a 10-day time horizon which cannot appropriately reflect the dynamics of rating migrations, which occur on an irregular, infrequent basis. This deficiency was one of the main reasons underlying the introduction of a separate risk measure for the capture of both credit default and rating migration risks, based on a one-year time horizon (the IRC models in article 372 of the *EU CRR* (Internal IRC model)).

(5) Since the challenges of appropriately capturing credit-rating migrations in an internal VaR model are high, the *FCA* expects a *firm* to demonstrate a strong case for the granting of the permission set out in article 162(2)(i) of the *EU CRR*.

4

(6) A *firm* that wishes to make an application under article 162(2)(i) of the *EU CRR* should provide a satisfactory justification for use of its internal VaR model to capture the risks associated with ratings migration. The purpose of reducing the *own funds requirements* for counterparty credit risk will not be considered as a reasonable justification.

(7) The *FCA* expects highly conservative modelling assumptions for the capture of rating migrations within a *firm*'s internal VaR models for specific risk associated with traded debt instruments under article 162(2)(i) of the *EU CRR* (Maturity).

4.15 Credit risk mitigation

Conditions for applying 0% volatility adjustment under the Financial Collateral Comprehensive Method

4.15.1 G For purposes of repurchase transactions and securities lending or borrowing transactions, the *FCA* does not consider that there are any core market participants apart from those entities listed in article 227(3) of the *EU CRR*.

4 Annex 1G Slotting criteria

Table 1 - Supervisory rating grades for project finance exposures				
	Strong	Good	Satisfactory	Weak
Financial strength				
Market conditions	Few competing suppliers or substantial and durable advantage in location, cost, or technology. Demand is strong and growing	Few competing suppliers or better than average location, cost, or technology but this situation may not last. Demand is strong and stable	Project has no advantage in location, cost, or technology. Demand is adequate and stable	Project has worse than average location, cost, or technology. Demand is weak and declining
Financial ratios (eg, debt service coverage ratio (DSCR), loan life coverage ratio (LLCR), project life coverage ratio (PLCR), and debt-to-equity ratio)	Strong financial ratios considering the level of project risk; very robust economic assumptions	Strong to acceptable financial ratios considering the level of project risk; robust project economic assumptions	Standard financial ratios considering the level of project risk	Aggressive financial ratios considering the level of project risk
Stress analysis	The project can meet its financial obligations under sustained, severely stressed economic or sectoral conditions	The project can meet its financial obligations under normal stressed economic or sectoral conditions. The project is only likely to default under severe economic conditions	The project is vulnerable to stresses that are not uncommon through an economic cycle, and may default in a normal downturn	The project is likely to default unless conditions improve soon
Financial structure				
Duration of the credit compared to the duration of the project	Useful life of the project significantly exceeds tenor of the loan	Useful life of the project exceeds tenor of the loan	Useful life of the project exceeds tenor of the loan	Useful life of the project may not exceed tenor of the loan
Amortisation schedule	Amortising debt	Amortising debt	Amortising debt repayments with limited bullet payment	Bullet repayment or amortising debt repayments with high bullet repayment
Political and legal environment				
Political risk, including transfer risk, considering project type and mitigants	Very low exposure; strong mitigation instruments, if needed	Low exposure; satisfactory mitigation instruments, if needed	Moderate exposure; fair mitigation instruments	High exposure; no or weak mitigation instruments

Table 1 - Supervisory rating grades for project finance exposures				
	Strong	Good	Satisfactory	Weak
Force majeure risk (war, civil unrest, etc)	Low exposure	Acceptable exposure	Standard protection	Significant risks, not fully mitigated
Government support and project's importance for the country over the long term	Project of strategic importance for the country (preferably export-oriented). Strong support from Government	Project considered important for the country. Good level of support from Government	Project may not be strategic but brings unquestionable benefits for the country. Support from Government may not be explicit	Project not key to the country. No or weak support from Government
Stability of legal and regulatory environment (risk of change in law	Favourable and stable regulatory environment over the long term	Favourable and stable regulatory environment over the medium term	Regulatory changes can be predicted with a fair level of certainty	Current or future regulatory issues may affect the project
Acquisition of all necessary supports and approvals for such relief from local content laws	Strong	Satisfactory	Fair	Weak
Enforceability of contracts, collateral and security	Contracts, collateral and security are enforceable	Contracts, collateral and security are enforceable	Contracts, collateral and security are considered enforceable even if certain non-key issues may exist	There are unresolved key issues for actual enforcement of contracts, collateral and security
Transaction characteristics				
Design and technology risk	Fully proven technology and design	Fully proven technology and design	Proven technology and design and start-up issues are mitigated by a strong completion package	Unproven technology and design; technology issues exist and/or complex design
Construction risk				
Permitting and siting	All permits have been obtained	Some permits are still outstanding but their receipt is considered very likely	Some permits are still outstanding but the permitting process is well defined and they are considered routine	Key permits still need to be obtained and are not considered routine. Significant conditions may be attached
Type of construction contract	Fixed-price date-certain turnkey construction EPC (engineering and procurement contract)	Fixed-price date-certain turnkey construction EPC	Fixed-price date-certain turnkey construction contract with one or several contractors	No or partial fixed-price turnkey contract and/or interfacing issues with multiple contractors
Completion guarantees	Substantial liquidated damages, supported by financial substance and/or strong completion guarantee from sponsors	Significant liquidated damages, supported by financial substance and/or completion guarantee from sponsors with	Adequate liquidated damages, supported by financial substance and/or completion guarantee from sponsors with	Inadequate liquidated damages or not supported by financial substance or weak completion guarantees

Table 1 - Supervisory rating grades for project finance exposures				
	Strong	Good	Satisfactory	Weak
	with excellent financial standing	good financial standing	good financial standing	
Track record and financial strength of contractor in constructing similar projects	Strong	Good	Satisfactory	Weak
Operating risk				
Scope and nature of operations and maintenance (O & M) contracts	Strong long-term O&M contract, preferably with contractual performance incentives, and/or O&M reserve accounts	Long-term O&M contract, and/or O&M reserve accounts	Limited O&M contract or O&M reserve account	No O&M contract risk of high operational cost overruns beyond mitigants
Operator's expertise, track record, and financial strength	Very strong, or committed technical assistance of the sponsors	Strong	Acceptable	Limited/weak, or local operator dependent on local authorities
Off-take risk				
(a) If there is a take-or-pay or fixed-price off-take contract:	Excellent creditworthiness of off-taker; strong termination clauses; tenor of contract comfortably exceeds the maturity of the debt	Good creditworthiness of off-taker; strong termination clauses; tenor of contract exceeds the maturity of the debt	Acceptable financial standing of off-taker; normal termination clauses; tenor of contract generally matches the maturity of the debt	Weak off-taker; weak termination clauses; tenor of contract does not exceed the maturity of the debt
(b) If there is no take-or-pay or fixed-price off-take contract:	Project produces essential services or a commodity sold widely on a world market; output can readily be absorbed at projected prices, even at lower than historic market growth rates	Project produces essential services or a commodity sold widely on a regional market that will absorb it at projected prices at historical growth rates	Commodity is sold on a limited market that may absorb it only at lower than projected prices	Project output is demanded by only one or a few buyers or is not generally sold on an organised market
Supply risk				
Price, volume and transportation risk of feed-stocks; supplier's track record and financial strength	Long-term supply contract with supplier of excellent financial standing	Long-term supply contract with supplier of good financial standing	Long-term supply contract with supplier of good financial standing - a degree of price risk may remain	Short-term supply contract or long-term supply contract with financially weak supplier - a degree of price risk definitely remains
Reserve risks (eg, natural resource development)	Independently audited, proven and developed reserves well in excess of requirements over lifetime of the project	Independently audited, proven and developed reserves in excess of requirements over the lifetime of the project	Proven reserves can supply the project adequately through the maturity of the debt	Project relies to some extent on potential and undeveloped reserves

4

Table 1 - Supervisory rating grades for project finance exposures				
	Strong	Good	Satisfactory	Weak
Strength of sponsor				
Sponsor's track record, financial strength, and country/sector experience	Strong sponsor with excellent track record and high financial standing	Good sponsor with satisfactory track record and good financial standing	Adequate sponsor with adequate track record and good financial standing	Weak sponsor with no or questionable track record and/or financial weaknesses
Sponsor support, as evidenced by equity, ownership clause and incentive to inject additional cash if necessary	Strong. Project is highly strategic for the sponsor (core business - long-term strategy)	Good. Project is strategic for the sponsor (core business - long-term strategy)	Acceptable. Project is considered important for the sponsor (core business)	Limited. Project is not key to sponsor's long-term strategy or core business
Security package				
Assignment of contracts and accounts	Fully comprehensive	Comprehensive	Acceptable	Weak
Pledge of assets, taking into account quality, value and liquidity of assets	First perfected security interest in all project assets, contracts, permits and accounts necessary to run the project	Perfected security interest in all project assets, contracts, permits and accounts necessary to run the project	Acceptable security interest in all project assets, contracts, permits and accounts necessary to run the project	Little security or collateral for lenders; weak negative pledge clause
Lender's control over cash flow (eg, cash sweeps, independent escrow accounts)	Strong	Satisfactory	Fair	Weak
Strength of the covenant package (mandatory prepayments, payment deferrals, payment cascade, dividend restrictions, etc)	Covenant package is strong for this type of project Project may issue no additional debt	Covenant package is satisfactory for this type of project Project may issue extremely limited additional debt	Covenant package is fair for this type of project Project may issue limited additional debt	Covenant package is insufficient for this type of project Project may issue unlimited additional debt
Reserve funds (debt service, O&M, renewal and replacement, unforeseen events, etc)	Longer than average coverage period, all reserve funds fully funded in cash or letters of credit from highly rated bank	Average coverage period, all reserve funds fully funded	Average coverage period, all reserve funds fully funded	Shorter than average coverage period, reserve funds funded from operating cash flows

Table 2 - Supervisory rating grades for income-producing real estate exposures				
	Strong	Good	Satisfactory	Weak
Financial strength				
Market conditions	The supply and demand for the project's type and location are currently in equilibrium. The number	The supply and demand for the project's type and location are currently in equilibrium. The number	Market conditions are roughly in equilibrium. Competitive properties are coming on the market and	Market conditions are weak. It is uncertain when conditions will improve and return to equilibrium.

4

Table 2 - Supervisory rating grades for income-producing real estate exposures	Strong	Good	Satisfactory	Weak
	of competitive properties coming to market is equal or lower than forecasted demand	of competitive properties coming to market is roughly equal to forecasted demand	others are in the planning stages. The project's design and capabilities may not be state of the art compared to new projects	The project is losing tenants at lease expiration. New lease terms are less favourable compared to those expiring
Financial ratios and advance rate	The property's debt service coverage ratio (DSCR) is considered strong (DSCR is not relevant for the construction phase) and its loan-to-value ratio (LTV) is considered low given its property type. Where a secondary market exists, the transaction is underwritten to market standards	The DSCR (not relevant for development real estate) and LTV are satisfactory. Where a secondary market exists, the transaction is underwritten to market standards	The property's DSCR has deteriorated and its value has fallen, increasing its LTV	The property's DSCR has deteriorated significantly and its LTV is well above underwriting standards for new loans
Stress analysis	The property's resources, contingencies and liability structure allow it to meet its financial obligations during a period of severe financial stress (eg, interest rates, economic growth)	The property can meet its financial obligations under a sustained period of financial stress (eg, interest rates, economic growth). The property is likely to default only under severe economic conditions	During an economic downturn, the property would suffer a decline in revenue that would limit its ability to fund capital expenditures and significantly increase the risk of default	The property's financial condition is strained and is likely to default unless conditions improve in the near term
Cash-flow predictability				
(a) For complete and stabilised property	The property's leases are long-term with creditworthy tenants and their maturity dates are scattered. The property has a track record of tenant retention upon lease expiration. Its vacancy rate is low. Expenses (maintenance, insurance, security and property taxes) are predictable	Most of the property's leases are long term, with tenants that range in creditworthiness. The property experiences a normal level of tenant turnover upon lease expiration. Its vacancy rate is low. Expenses are predictable	Most of the property's leases are medium rather than long term, with tenants that range in creditworthiness. The property experiences a moderate level of tenant turnover upon lease expiration. Its vacancy rate is moderate. Expenses are relatively predictable but vary in relation to revenue	The property's leases are of various terms with tenants that range in creditworthiness. The property experiences a very high level of tenant turnover upon lease expiration. Its vacancy rate is high. Significant expenses are incurred preparing space for new tenants
(b) For complete	Leasing activity	Leasing activity	Most leasing activ-	Market rents do

4

Table 2 - Supervisory rating grades for income-producing real estate exposures	Strong	Good	Satisfactory	Weak
but not stabilised property	meets or exceeds projections. The project should achieve stabilisation in the near future	meets or exceeds projections. The project should achieve stabilisation in the near future	ity is within projections; however, stabilisation will not occur for some time	not meet expectations. Despite achieving target occupancy rate, cash flow coverage is tight due to disappointing revenue
(c) For construction phase	The property is entirely pre-leased through the tenor of the loan or pre-sold to an investment grade tenant or buyer, or the bank has a binding commitment for take-out financing from an investment grade lender	The property is entirely pre-leased or pre-sold to a creditworthy tenant or buyer, or the bank has a binding commitment for permanent financing from a creditworthy lender	Leasing activity is within projections but the building may not be pre-leased and there may not exist a take-out financing. The bank may be the permanent lender	The property is deteriorating due to cost overruns, market deterioration, tenant cancellations or other factors. There may be a dispute with the party providing the permanent financing
Asset characteristics				
Location	Property is located in highly desirable location that is convenient to services that tenants desire	Property is located in desirable location that is convenient to services that tenants desire	The property location lacks a competitive advantage	The property's location, configuration, design and maintenance have contributed to the property's difficulties
Design and condition	Property is favoured due to its design, configuration, and maintenance, and is highly competitive with new properties	Property is appropriate in terms of its design, configuration and maintenance. The property's design and capabilities are competitive with new properties	Property is adequate in terms of its configuration, design and maintenance	Weaknesses exist in the property's configuration, design or maintenance
Property is under construction	Construction budget is conservative and technical hazards are limited. Contractors are highly qualified	Construction budget is conservative and technical hazards are limited. Contractors are highly qualified	Construction budget is adequate and contractors are ordinarily qualified	Project is over budget or unrealistic given its technical hazards. Contractors may be under qualified
Strength of sponsor/ developer				
Financial capacity and willingness to support the property	The sponsor/ developer made a substantial cash contribution to the construction or purchase of the property. The sponsor/ developer has substantial resources and limited direct and	The sponsor/ developer made a material cash contribution to the construction or purchase of the property. The sponsor/ developer's financial condition allows it to support the	The sponsor/ developer's contribution may be immaterial or non-cash. The sponsor/ developer is average to below-average in financial resources	The sponsor/ developer lacks capacity or willingness to support the property

4

Table 2 - Supervisory rating grades for income-producing real estate exposures	Strong	Good	Satisfactory	Weak
	contingent liabilities. The sponsor/ developer's properties are diversified geographically and by property type	property in the event of a cash flow shortfall. The sponsor/ developer's properties are located in several geographic region		
Reputation and track record with similar properties	Experienced management and high sponsor quality. Strong reputation and lengthy and successful record with similar properties	Appropriate management and sponsor quality. The sponsor or management has a successful record with similar properties	Moderate management and sponsor quality. Management or sponsor track record does not raise serious concerns	Ineffective management and substandard sponsor quality. Management and sponsor difficulties have contributed to difficulties in managing properties in the past
Relationships with relevant real estate actors	Strong relationships with leading actors, such as leasing agents	Proven relationships with leading actors, such as leasing agents	Adequate relationships with leasing agents and other parties providing important real estate services	Poor relationships with leasing agents and/or other parties providing important real estate services
Security package				
Nature of lien	Perfected first lien (Note 1)	Perfected first lien (Note 1)	Perfected first lien (Note 1)	Ability of lender to foreclose is constrained
Assignment of rents (for projects leased to long-term tenants)	The lender has obtained an assignment. They maintain current tenant information that would facilitate providing notice to remit rents directly to the lender, such as a current rent roll and copies of the project's leases	The lender has obtained an assignment. They maintain current tenant information that would facilitate providing notice to the tenants to remit rents directly to the lender, such as current rent roll and copies of the project's leases	The lender has obtained an assignment. They maintain current tenant information that would facilitate providing notice to the tenants to remit rents directly to the lender, such as current rent roll and copies of the project's leases	The lender has not obtained an assignment of the leases or has not maintained the information necessary to readily provide notice to the building's tenants
Quality of the insurance coverage	Appropriate	Appropriate	Appropriate	Substandard
Note 1: Lenders in some markets extensively use loan structures that include junior liens. Junior liens may be indicative of this level of risk if the total LTV inclusive of all senior positions does not exceed a typical first loan LTV.				

Table 3 - Supervisory rating grades for object finance exposures	Strong	Good	Satisfactory	Weak
Financial strength				
Market conditions	Demand is strong and growing, strong entry barriers, low sensitiv-	Demand is strong and stable. Some entry barriers, some sensitivity to	Demand is adequate and stable, limited entry barriers, significant	Demand is weak and declining, vulnerable to changes in techno-

4

Table 3 - Supervisory rating grades for object finance exposures				
	Strong	Good	Satisfactory	Weak
	ity to changes in technology and economic outlook	changes in technology and economic outlook	sensitivity to changes in technology and economic outlook	logy and economic outlook, highly uncertain environment
Financial ratios (debt service coverage ratio and loan-to-value ratio)	Strong financial ratios considering the type of asset. Very robust economic assumptions	Strong / acceptable financial ratios considering the type of asset. Robust project economic assumptions	Standard financial ratios for the asset type	Aggressive financial ratios considering the type of asset
Stress analysis	Stable long-term revenues, capable of withstanding severely stressed conditions through an economic cycle	Satisfactory short-term revenues. Loan can withstand some financial adversity. Default is only likely under severe economic conditions	Uncertain short-term revenues. Cash flows are vulnerable to stresses that are not uncommon through an economic cycle. The loan may default in a normal downturn	Revenues subject to strong uncertainties; even in normal economic conditions the asset may default, unless conditions improve
Market liquidity	Market is structured on a worldwide basis; assets are highly liquid	Market is worldwide or regional; assets are relatively liquid	Market is regional with limited prospects in the short term, implying lower liquidity	Local market and/or poor visibility. Low or no liquidity, particularly on niche markets
Political and legal environment				
Political risk, including transfer risk	Very low; strong mitigation instruments, if needed	Low; satisfactory mitigation instruments, if needed	Moderate; fair mitigation instruments	High; no or weak mitigation instruments
Legal and regulatory risks	Jurisdiction is favourable to repossession and enforcement of contracts	Jurisdiction is favourable to repossession and enforcement of contracts	Jurisdiction is generally favourable to repossession and enforcement of contracts, even if repossession might be long and/or difficult	Poor or unstable legal and regulatory environment. Jurisdiction may make repossession and enforcement of contracts lengthy or impossible
Transaction characteristics				
Financing term compared to the economic life of the asset	Full pay-out profile/minimum balloon. No grace period	Balloon more significant, but still at satisfactory levels	Important balloon with potentially grace periods	Repayment in fine or high balloon
Operating risk				
Permits / licensing	All permits have been obtained; asset meets current and foreseeable safety regulations	All permits obtained or in the process of being obtained; asset meets current and foreseeable safety regulations	Most permits obtained or in process of being obtained, outstanding ones considered routine, asset meets current safety regulations	Problems in obtaining all required permits, part of the planned configuration and/or planned operations might need to be revised

Table 3 - Supervisory rating grades for object finance exposures

	Strong	Good	Satisfactory	Weak
Scope and nature of O & M contracts	Strong long-term O & M contract, preferably with contractual performance incentives, and/or O & M reserve accounts (if needed)	Long-term O & M contract, and/or O & M reserve accounts (if needed)	Limited O & M contract or O & M reserve account (if needed)	No O & M contract: risk of high operational cost overruns beyond mitigants
Operator's financial strength, track record in managing the asset type and capability to re-market asset when it comes off-lease	Excellent track record and strong re-marketing capability	Satisfactory track record and re-marketing capability	Weak or short track record and uncertain re-marketing capability	No or unknown track record and inability to re-market the asset
Asset characteristics				
Configuration, size, design and maintenance (ie, age, size for a plane) compared to other assets on the same market	Strong advantage in design and maintenance. Configuration is standard such that the object meets a liquid market	Above average design and maintenance. Standard configuration, maybe with very limited exceptions - such that the object meets a liquid market	Average design and maintenance. Configuration is somewhat specific, and thus might cause a narrower market for the object	Below average design and maintenance. Asset is near the end of its economic life. Configuration is very specific; the market for the object is very narrow
Resale value	Current resale value is well above debt value	Resale value is moderately above debt value	Resale value is slightly above debt value	Resale value is below debt value
Sensitivity of the asset value and liquidity to economic cycles	Asset value and liquidity are relatively insensitive to economic cycles	Asset value and liquidity are sensitive to economic cycles	Asset value and liquidity are quite sensitive to economic cycles	Asset value and liquidity are highly sensitive to economic cycles
Strength of sponsor				
Operator's financial strength, track record in managing the asset type and capability to re-market asset when it comes off-lease	Excellent track record and strong re-marketing capability	Satisfactory track record and re-marketing capability	Weak or short track record and uncertain re-marketing capability	No or unknown track record and inability to re-market the asset
Sponsors' track record and financial strength	Sponsors with excellent track record and high financial standing	Sponsors with good track record and good financial standing	Sponsors with adequate track record and good financial standing	Sponsors with no or questionable track record and/ or financial weaknesses
Security package				
Asset control	Legal documentation provides the lender effective control (eg, a first perfected security	Legal documentation provides the lender effective control (eg, a perfected security in-	Legal documentation provides the lender effective control (eg, a perfected security in-	The contract provides little security to the lender and leaves room to some risk of losing

4

Table 3 - Supervisory rating grades for object finance exposures	Strong	Good	Satisfactory	Weak
	interest, or a leasing structure including such security) on the asset, or on the company owning it	terest, or a leasing structure including such security) on the asset, or on the company owning it	terest, or a leasing structure including such security) on the asset, or on the company owning it	control on the asset
Rights and means at the lender's disposal to monitor the location and condition of the asset	The lender is able to monitor the location and condition of the asset, at any time and place (regular reports, possibility to lead inspections)	The lender is able to monitor the location and condition of the asset, almost at any time and place	The lender is able to monitor the location and condition of the asset, almost at any time and place	The lender is able to monitor the location and condition of the asset are limited
Insurance against damages	Strong insurance coverage including collateral damages with top quality insurance companies	Satisfactory insurance coverage (not including collateral damages) with good quality insurance companies	Fair insurance coverage (not including collateral damages) with acceptable quality insurance companies	Weak insurance coverage (not including collateral damages) or with weak quality insurance companies

Table 4 - Supervisory rating grades for commodities finance exposures	Strong	Good	Satisfactory	Weak
Financial strength				
Degree of over-collateralisation of trade	Strong	Good	Satisfactory	Weak
Political and legal environment				
Country risk	No country risk	Limited exposure to country risk (in particular, offshore location of reserves in an emerging country)	Exposure to country risk (in particular, offshore location of reserves in an emerging country)	Strong exposure to country risk (in particular, inland reserves in an emerging country)
Mitigation of country risks	Very strong mitigation: Strong offshore mechanisms Strategic commodity 1st class buyer	Strong mitigation: Offshore mechanisms Strategic commodity Strong buyer	Acceptable mitigation: Offshore mechanisms Less strategic commodity Acceptable buyer	Only partial mitigation: No offshore mechanisms Non-strategic commodity Weak buyer
Asset characteristics				
Liquidity and susceptibility to damage	Commodity is quoted and can be hedged through futures or OTC instruments. Commod	Commodity is quoted and can be hedged through OTC instruments. Commodity is not sus-	Commodity is not quoted but is liquid. There is uncertainty about the possibility of hedging. Com-	Commodity is not quoted. Liquidity is limited given the size and depth of the market. No appropri-

Table 4 - Supervisory rating grades for commodities finance exposures	Strong	Good	Satisfactory	Weak
	ity is not susceptible to damage	ceptible to damage	modity is not susceptible to damage	ate hedging instruments. Commodity is susceptible to damage
Strength of sponsor				
Financial strength of trader	Very strong, relative to trading philosophy and risks	Strong	Adequate	Weak
Track record, including ability to manage the logistic process	Extensive experience with the type of transaction in question. Strong record of operating success and cost efficiency	Sufficient experience with the type of transaction in question. Above average record of operating success and cost efficiency	Limited experience with the type of transaction in question. Average record of operating success and cost efficiency	Limited or uncertain track record in general. Volatile costs and profits
Trading controls and hedging policies	Strong standards for counterparty selection, hedging, and monitoring	Adequate standards for counterparty selection, hedging, and monitoring	Past deals have experienced no or minor problems	Trader has experienced significant losses on past deals
Quality of financial disclosure	Excellent	Good	Satisfactory	Financial disclosure contains some uncertainties or is insufficient
Security package				
Asset control	First perfected security interest provides the lender legal control of the assets at any time if needed	First perfected security interest provides the lender legal control of the assets at any time if needed	At some point in the process, there is a rupture in the control of the assets by the lender. The rupture is mitigated by knowledge of the trade process or a third party undertaking as the case may be	Contract leaves room for some risk of losing control over the assets. Recovery could be jeopardised
Insurance against damages	Strong insurance coverage including collateral damages with top quality insurance companies	Satisfactory insurance coverage (not including collateral damages) with good quality insurance companies	Fair insurance coverage (not including collateral damages) with acceptable quality insurance companies	Weak insurance coverage (not including collateral damages) or with weak quality insurance companies

4 Annex 2G Wholesale LGD and EAD framework

1. The following framework should be used to assess wholesale LGD models in the circumstances set out in IFPRU 4.7.15 G:
   - (a) For unsecured recoveries if a *firm* has fewer than 20 relevant default observations of recoveries in a specific country for an individual type of *exposure*, then the maximum recovery a *firm* can assume should be equivalent to that which would give a 45% LGD for senior unsecured *exposures*, 75% for subordinated *exposures* and 11.25% for covered bonds.
   - (b) If a *firm* is taking account of non-financial collateral which is not eligible under the foundation approach where it does not have 20 or more relevant data points of recovery values for that type of collateral or does not have a reliable time series of market price data for the collateral in a specific country, then the LGD for the *exposure* to which the collateral is applied should be floored at 45%.
   - (c) If a *firm* is taking account of non-financial collateral which is eligible under the foundation approach, where it does not have 20 or more relevant data points of recovery values for that type of collateral or does not have a reliable time series of market price data for that collateral in a specific country, then the LGD for the *exposure* to which the collateral is applied should be floored at 35%.
2. *Firms* should note the following when applying the framework to LGD models:
   - (a) The 20 or more relevant data points can include internal or external data. However, the *FCA* expects *firms* to ensure that each data point is independent, representative and an accurate record of the recovery for that exposure or collateral type in that specific country.
   - (b) The *FCA* anticipates that *firms* are able to use market price data within the framework where they have less than 20 defaults only in exceptional circumstances. As a minimum, *firms* need to demonstrate that the market price data being used is representative of their collateral and that it is over a long enough time period to ensure that an appropriate downturn and forced sale haircut can be estimated.
   - (c) The framework does not affect the use of financial collateral.
   - (d) The framework does not affect the use of unfunded credit protection.
   - (e) Where a model takes account of multiple collateral types, if this only includes collateral that is eligible under the foundation approach then LGDs should be floored at 35%, and if any collateral type is not eligible under the foundation approach then LGDs should be floored at 45%.
   - (f) The effect of this framework is to floor bank and non-bank financial institution (NBFI) *exposures* at foundation values unless sufficient country-specific recovery data is available. This floor should be applied where the *exposures* are to types of banks and NBFIs that are not sufficiently represented in the available historic data (eg, if the historic recovery data only relates to small banks then the floor will affect large banks).
   - (g) When applying the framework, the *FCA* expects *firms* to assess whether the 11.25% LGD floor for covered bonds is sufficient given the quality of the underlying assets
3. *Firms* should select the most appropriate of the following three options when using the framework to assess wholesale EAD models in the circumstances set out in IFPRU 4.8.9 G:
   - (a) rank-order the off balance sheet product types (separately for lending and trade finance) according to their drawdown risk. The EAD parameter for a product with 20 or more default observations can then be applied to low-default products with a lower drawdown risk; or

4

(b) for product types where the *firm* has the defaults needed to estimate the EAD for committed credit lines (or an estimate derived from the option above) but less than 20 defaults for uncommitted credit lines, use 50% of the committed credit line conversion factor as an estimate of the uncommitted credit line conversion factor; or

(c) apply the foundation parameters.

4. *Firms* should note the following when applying the framework to EAD models:

(a) *Firms* may select more than one option when applying the framework, providing that they can demonstrate that their chosen combination is appropriate, reflecting their particular mix of products and risks, and is not selected to minimise their *own funds requirements*.

(b) As the *FCA* believes that the EAD experienced by *firms* is dependent on their own credit management processes it would expect only internal data to be used to estimate EAD. However, where *firms* can convincingly demonstrate to the *FCA*'s satisfaction that the credit process are consistent across countries then the *FCA* would accept that data sourced from these countries could be combined to estimate the EAD for each product (ie, the 20 default data points do not have to be country specific for the purposes of estimating EAD).

(c) *Firms* using the option in (a), above, should be able to demonstrate that a sufficiently robust approach has been taken to rank-ordering their product types by drawdown risk. This approach must be fully documented and assessed by an independent reviewer.

Chapter 5

Operational risk

5

5.1 Application and purpose

Application

5.1.1 R IFPRU 5 applies to a *full-scope IFPRU investment firm*, unless it is an *exempt IFPRU commodities firm*.

Purpose

5.1.2 G This chapter contains *guidance* to help a *firm* understand the *FCA*'s expectations on the extent to which the Advanced Measurement Approach (AMA) should capture its *operational risks* where the *firm* has, or is about to, implement AMA.

5

5.2 Advanced Measurement Approach permission

5.2.1 G This is relevant where the AMA is applied across only part of a *firm*'s operations and is used in conjunction with either the Basic Indicator Approach (BIA), or the Standardised Approach (TSA).

5.2.2 G A *firm* may use an AMA in combination with the BIA or TSA, provided it obtains permission from the *FCA*. In granting such permission, the *FCA* is required by article 314(3) of the *EU CRR* (Combined use of different approaches) to impose the following conditions when the AMA is used in combination with BIA or TSA:

(1) on the date of first implementation of the AMA, a 'significant' part of the *institution*'s *operational risk* are captured by that approach; and

(2) the *institution* to commit to apply the AMA across a 'material' part of its operations within a time schedule approved by the *FCA*.

5.2.3 G For the purposes of these conditions, the *FCA* considers that:

(1) a "significant" part of *operational risk* shall be approximately 50% (or more); and

(2) a 'material' part of its operations shall be around 85% (or more).

Chapter 6

Market risk

6

6.1 Market risk requirements

6.1.1 R IFPRU 6 applies to an *IFPRU investment firm*, unless it is an *exempt IFPRU commodities firm*.

Purpose

6.1.2 G This chapter:

(1) implements article 101 of *CRD*;

(2) contains the rule that exercises the discretion afforded to the *FCA* as *competent authority* under article 327(2) of the *EU CRR*; and

(3) contains the *guidance* for market risk.

Instruments for which no treatment specified

6.1.3 R (1) Where a *firm* has a position in a *financial instrument* for which no treatment has been specified in the *EU CRR*, it must calculate its *own funds requirement* by applying the most appropriate requirement relating to positions that are specified in the *EU CRR*, if doing so is prudent and appropriate, and if the position is sufficiently similar to those covered by the relevant requirement.

(2) A *firm* must document its policies and procedures for calculating *own funds* for such positions in its trading book policy statement.

(3) If there are no appropriate treatments, the *firm* must calculate an *own funds requirement* of an appropriate percentage of the current value of the position. An appropriate percentage is either 100%, or a percentage that takes into account the characteristics of the position.

Use of internal models: risk capture

6.1.4 R A *firm* which has a permission to use internal models in accordance with Part Three, Title IV, Chapter 5 of the *EU CRR* (Own funds requirements for market risk):

(1) must identify any material risk, or risks that when considered in aggregate are material, which are not captured by those models;

(2) must ensure that it holds *own funds* to cover those risk(s) in addition to those required to meet its *own funds requirement* calculated in accordance with Part Three, Title IV, Chapter 5 of the *EU CRR*; and

(3) (where applicable) must ensure that it holds additional *own funds requirements* for VaR and stressed VaR models.

[**Note:** article 101 of CRD]

6.1.5 G

(1) The methodology for the identification of the risks in IFPRU 6.1.4 R and the calculation of those additional *own funds* for value-at-risk (VaR) and stressed value-at-risk (stressed VaR) models is called the "RNIV framework". A *firm* is responsible for identifying these additional risks and this should be an opportunity for risk managers and management to better understand the shortcomings of the *firm*'s models. Following this initial assessment, the *FCA* will engage with the *firm* to provide challenge and ensure an appropriate outcome.

(2) The RNIV framework is intended to ensure that *own funds* are held to meet all risks which are not captured or not captured adequately, by the *firm*'s VaR and stressed VaR models. These include, but are not limited to, missing and/or illiquid risk factors such as cross-risks, basis risks, higher-order risks, and calibration parameters. The RNIV framework is also intended to cover event risks that could adversely affect the relevant business.

(3) A *firm* should systematically identify and measure all non-captured or poorly captured risks. This analysis should be updated at least quarterly, or more frequently at the request of the *FCA*. The measurement of these risks should capture the losses that could arise due to the risk factor(s) of all products that are within the scope of the relevant internal model permission, but are not adequately captured by the relevant internal models.

(4) On a quarterly basis, the *firm* should identify and assess individual risk factors covered by the RNIV framework. The *FCA* will review the results of this exercise and may require that *firms* identify additional risk factors as being eligible for measurement.

(5) (a) Where sufficient data is available, and where it is appropriate to do so, the *FCA* expects a *firm* to calculate a VaR and stressed VaR metric for each risk factor within scope of the framework. The stressed period for the RNIV framework should be consistent with that used for stressed VaR. No offsetting or diversification may be recognised across risk factors included in the RNIV framework. The multipliers used for VaR and stressed VaR should be applied to generate an *own funds requirement*.

(b) If it is not appropriate to calculate a VaR and stressed VaR metric for a risk factor, a *firm* should instead measure the size of the risk based on a stress test. The confidence level and capital horizon of the stress test should be commensurate with the liquidity of the risk, and should be at least as conservative as comparable risk factors under the internal model approach. The capital charge should be at least equal to the losses arising from the stress test.

Standardised approach for options

6.1.6 G A *firm* that wishes to use own estimates for delta for the purposes of the standardised approach for options, should provide the *FCA* with confirmation that it meets the minimum standards set out in IFPRU 6.1.8 G to IFPRU 6.1.15 R (Minimum standards for own estimates of delta) for each type of option for which it calculates delta. Where a *firm* meets the minimum standards, it can expect to be permitted to use own estimates of delta for the relevant option.

6.1.7 G If a *firm* is unable to provide assurance with regard to a particular option type which is currently within its permissions, a capital add-on may be applied and a rectification plan agreed. If a *firm* is unable to comply with the rectification plan within the mandated time-frame, further supervisory measures may be taken. This may include variation of a *firm*'s *Part 4A permission* so that it is no longer allowed to trade those particular types of options for which it does not meet the minimum standards.

6

Minimum standards for own estimates of delta

6.1.8 G The level of sophistication of the pricing models used to calculate own estimates of delta for use in the standardised approach for options should be proportionate to the complexity and risk of each option, and the overall risk of the *firm*'s options trading business. In general, it is considered that the risk of sold options will be higher than the risk of the same options when bought.

6.1.9 G Delta should be re-calculated at least daily. A *firm* should also recalculate delta promptly following significant movements in the market parameters used as inputs to calculate delta.

6.1.10 G The pricing model used to calculate delta should be:

(1) based on appropriate assumptions which have been assessed and challenged by suitably qualified parties independent of the development process;

(2) independently tested, including validation of the mathematics, assumptions, and software implementation; and

(3) developed or approved independently of the trading desk.

6.1.11 G A *firm* should use generally accepted industry standard pricing models for the calculation of own deltas where these are available, such as for relatively simple options.

6.1.12 G The IT systems used to calculate delta should be sufficient to ensure that delta can be reliably calculated accurately and reliably.

6.1.13 G A *firm* should have adequate systems and controls in place when using pricing models to calculate deltas. This should include the following documented policies and procedures:

(1) clearly defined responsibilities of the various areas involved in the calculation;

(2) frequency of independent testing of the accuracy of the model used to calculate delta; and

(3) guidelines for the use of unobservable inputs, where relevant.

6.1.14 G A *firm* should ensure its risk management functions are aware of weaknesses of the model used to calculate deltas. Where weaknesses are identified, the *firm* should ensure that estimates of delta result in prudent *own funds requirements* being held. The outcome should be prudent across the whole portfolio of options and underlying positions at a given time.

6

Netting: convertible

6.1.15 R Under article 327(2) of the *EU CRR* (Netting), the netting of a *convertible* and an offsetting position in the underlying instrument is permitted.

6.1.16 G For the purpose of IFPRU 6.1.15 R, the *convertible* should be:

(1) treated as a position in the *equity* into which it converts; and

(2) the *firm*'s *own funds requirement* for the general and specific risk in its *equity* instruments should be adjusted by making:

(a) an addition equal to the current value of any loss which the *firm* would make if it did convert to *equity*; or

(b) a deduction equal to the current value of any profit which the *firm* would make if it did convert to *equity* (subject to a maximum deduction equal to the *own funds requirements* on the notional position underlying the convertible).

Use of internal approaches

6.1.17 G A *significant IFPRU firm* should consider developing internal specific risk assessment capacity and to increase use of internal models for calculating *own funds requirements* for specific risk of debt instruments in the *trading book*, together with internal models to calculate *own funds requirements* for default and migration risk where its exposures to specific risk are material in absolute terms and where it holds a large number of material positions in debt instruments of different issuers. This provision is without prejudice to the fulfilment of the criteria laid down in Part Three, Title IV, Chapter 5, Sections 1 to 5, of the *EU CRR* (Market risk).

[**Note:** article 77(3) of *CRD*]

6

6.2 Guidance on market risk

Offsetting derivative instruments

6.2.1 G Article 331(2) of the *EU CRR* (Interest rate risk in derivative instruments) states conditions that must be met before a *firm* not using interest rate pre-processing models can fully offset interest-rate risk on derivative instruments. One of the conditions is that the reference rate (for floating-rate positions) or coupon (for fixed-rate positions) should be 'closely matched'. The *FCA* will normally consider a difference of less than 15 basis points as indicative of the reference rate or coupon being 'closely matched' for the purposes of this requirement.

Exclusion of overshootings when determining multiplication factor addends

6.2.2 G (1) The *FCA*'s starting assumption is that all overshootings should be taken into account for the purpose of the calculation of addends. If a *firm* believes that an overshooting should not count for that purpose, then it should seek a variation of its VaR model permission under article 363 of the *EU CRR* (Permission to use internal models) in order to exclude that particular overshooting. The *FCA* would then decide whether to agree to such a variation.

(2) One example of when a *firm*'s overshooting might properly be disregarded is when it has arisen as a result of a risk that is not captured in its VaR model but against which *own funds* are already held.

Derivation of notional positions for standardised approaches

6.2.3 G The rest of this section sets out the *guidance* for the derivation of notional positions for standardised approaches.

Futures and forwards on a basket or index of debt securities

6.2.4 G Futures or forwards on a basket or index of debt securities should be converted into forwards on single debt securities as follows:

(1) futures or forwards on a single currency basket or index of debt securities should be treated as either:

(a) a series of forwards, one for each of the constituent debt securities in the basket or index, of an amount which is a proportionate part of the total underlying the contract, according to the weighting of the relevant debt security in the basket; or

(b) a single forward on a notional debt security; and

(2) futures or forwards on multiple currency baskets or indices of debt securities should be treated as either:

(a) a series of forwards (using the method in (1)(a)); or

(b) a series of forwards, each one on a notional debt security to represent one of the currencies in the basket or index, of an amount which is a proportionate part of the total underlying the contract according to the weighting of the relevant currency in the basket.

6.2.5 G Notional debt securities derived through this treatment should be assigned a specific risk position risk adjustment and a general market risk position risk adjustment equal to the highest that would apply to the debt securities in the basket or index.

6

6.2.6 G The debt security with the highest specific risk position risk adjustment within the basket might not be the same as the one with the highest general market risk position risk adjustment. A *firm* should select the highest percentages, even where they relate to different debt securities in the basket or index, and regardless of the proportion of those debt securities in the basket or index.

Bonds where coupons and principal are paid in different currencies

6.2.7 G Where a debt security pays coupons in one currency but will be redeemed in a different currency, it should be treated as:

(1) a debt security denominated in the coupon's currency; and

(2) a foreign currency forward to capture the fact that the debt security's principal will be repaid in a different currency from that in which it pays coupons, specifically:

(a) a notional forward sale of the coupon currency and purchase of the redemption currency, in the case of a long position in the debt security; or

(b) a notional forward purchase of the coupon currency and sale of the redemption currency, in the case of a short position in the debt security.

Interest-rate risk on other futures, forwards and swaps

6.2.8 G Other futures, forwards, and swaps where a treatment is not specified in article 328 of the *EU CRR* ((Interest rate futures and forwards) should be treated as positions in zero specific risk securities, each of which:

(1) has a zero coupon;

(2) has a maturity equal to that of the relevant contract; and

(3) is long or short according to the table in IFPRU 6.2.9 G.

6.2.9 G This table belongs to IFPRU 6.2.8 G.

Instrument	Notional positions		
Foreign currency forward or future	A long position denominated in the currency purchased	and	A short position denominated in the currency sold
Gold forward or future	A long position if the forward or future involves an actual (or notional) sale of gold	or	A short position if the forward or future involves an actual (or notional) purchase of gold
Equity forward or future	A long position if the contract involves an actual (or notional) sale of the underlying equity	or	A short position if the contract involves an actual (or notional) purchase of the underlying equity

6

Deferred start interest rate swaps or foreign currency swaps

6.2.10 G Interest-rate swaps or foreign currency swaps with a deferred start should be treated as the two notional positions (one long, one short). The paying leg should be treated as a short position in a zero specific risk security with a coupon equal to the fixed rate of the swap. The receiving leg should be treated as a long position in a zero specific risk security, which also has a coupon equal to the fixed rate of the swap.

6.2.11 G The maturities of the notional positions are shown in the table in IFPRU 6.2.12 G.

6.2.12 G This table belongs to IFPRU 6.2.11 G.

	Paying leg	Receiving leg
Receiving fixed and paying floating	The maturity equals the start date of the swap	The maturity equals the end date of the swap
Paying fixed and receiving floating	The maturity equals the end date of the swap	The maturity equals the start date of the swap

Swaps where only one leg is an interest-rate leg

6.2.13 G For interest-rate risk, a *firm* should treat a swap (such as an equity swap) with only one interest rate leg as a notional position in a zero specific risk security:

(1) with a coupon equal to that on the interest rate leg;

(2) with a maturity equal to the date that the interest rate will be reset; and

(3) which is a long position if the *firm* is receiving interest payments and short if making interest payments.

Foreign exchange forwards, futures and CFDs

6.2.14 G

(1) A *firm* should treat a foreign currency forward, future or CFD as two notional currency positions as follows:

(a) a long notional position in the currency which the *firm* has contracted to buy; and

(b) a short notional position in the currency which the *firm* has contracted to sell.

(2) In (1), the notional positions should have a value equal to either:

(a) the contracted amount of each currency to be exchanged in a forward, future or CFD held in the non-*trading book*; or

(b) the present value of the amount of each currency to be exchanged in a forward, future or CFD held in the *trading book*.

Foreign currency swaps

6.2.15 G

(1) A *firm* should treat a foreign currency swap as:

(a) a long notional position in the currency in which the *firm* has contracted to receive interest and principal; and

(b) a short notional position in the currency in which the *firm* has contracted to pay interest and principal.

(2) In (1), the notional positions should have a value equal to either:

(a) the nominal amount of each currency underlying the swap if it is held in the non-*trading book*; or

(b) the present value amount of all cash flows in the relevant currency in the case of a swap held in the *trading book*.

Futures, forwards and CFDs on a single commodity

6.2.16 G

Where a forward, future or CFD settles according to:

(1) the difference between the price set on trade date and that prevailing at contract expiry, then the notional position should:

(a) equal the total quantity underlying the contract; and

(b) have a maturity equal to the expiry date of the contract; and

(2) the difference between the price set on trade date and the average of prices prevailing over a certain period up to contract expiry, then a notional position should be derived for each of the reference dates used in the averaging period to calculate the average price, which:

(a) equals a fractional share of the total quantity underlying the contract; and

(b) has a maturity equal to the relevant reference date.

Buying or selling a single commodity at an average of spot prices prevailing in the future

6.2.17 G Commitments to buy or sell at the average spot price of the commodity prevailing over some period between trade date and maturity should be treated as a combination of:

(1) a position equal to the full amount underlying the contract with a maturity equal to the maturity date of the contract, which should be:

(a) long, where the *firm* will buy at the average price; or

(b) short, where the *firm* will sell at the average price; and

(2) a series of notional positions, one for each of the reference dates where the contract price remains unfixed, each of which should:

(a) be long if the position under (1) is short, or short if the position under (1) is long;

(b) equal to a fractional share of the total quantity underlying the contract; and

(c) have a maturity date of the relevant reference date.

Cash legs of repurchase agreements and reverse repurchase agreements

6.2.18 G The forward cash leg of a repurchase agreement or reverse repurchase agreement should be treated as a notional position in a zero specific risk security which:

(1) is a short notional position in the case of a repurchase agreement and a long notional position in the case of a reverse repurchase agreement;

(2) has a value equal to the market value of the borrowing or deposit;

(3) has a maturity equal to that of the borrowing or deposit, or the next date the interest rate is reset (if earlier); and

(4) has a coupon equal to:

(a) zero, if the next interest payment date coincides with the maturity date; or

(b) the interest rate on the borrowing or deposit, if any interest is due to be paid before the maturity date.

6.3 Expectations relating to internal models

6.3.1 G Article 363 of the *EU CRR* (Permission to use internal models) states that permission for an *institution* to use internal models to calculate *own funds requirements* is subject to *competent authorities* verifying compliance with:

(1) the general requirements;

(2) requirements particular to specific risk modelling; and

(3) requirements for an internal model for incremental default and migration risk.

6.3.2 G This section describes some of the standards that the *FCA* expects to be met for it to consider that a *firm* is compliant with the requirements in IFPRU 6.3.1 G.

High-level standards

6.3.3 G A *firm* should be able to demonstrate that it meets the risk management standards in article 368 of the *EU CRR* (Qualitative requirements) on a legal entity and business-line basis where appropriate. This is particularly important for a *subsidiary* in a *group* subject to matrix management where the business lines cut across legal entity boundaries.

Categories of position

6.3.4 G A VaR model permission will generally set out the broad classes of position within each risk category in its scope. It may also specify how individual products within one of those broad classes may be brought into or taken out of scope of the VaR model permission. These broad classes of permission are as follows:

(1) linear products, which comprise securities with linear pay-offs (such as bonds and *equities*) and derivative products which have linear pay-offs in the underlying risk factor (such as interest rate swaps, *FRA*s, and total return swaps);

(2) European, American and Bermudan put and call options (including caps, floors, and swaptions) and investments with these features;

(3) Asian options, digital options, single barrier options, double barrier options, look-back options, forward-starting options, compound options and investments with these features; and

(4) all other option-based products (such as basket options, quantos, outperformance options, timing options, and correlation-based products) and investments with these features.

Data standards

6.3.5 G A *firm* should ensure that the data series used by its VaR model is reliable. Where a reliable data series is not available, proxies or any other reasonable value-at-risk measurement may be used when the *firm* demonstrates that the requirements of article 367(2)(e) of the *EU CRR* (Requirements for risk measurement) are met. A *firm* should demonstrate that the technique is appropriate and does not materially understate the modelled risks

6.3.6 G Data may be deemed insufficient if, for example, it contains missing data points, or data points which contain stale data. With regard to less liquid risk factors or positions, the *FCA* expects the *firm* to make a conservative assessment of those risks, using a combination of prudent valuation techniques and alternative VaR estimation techniques to ensure there is a sufficient cushion against risk over the close-out period, which takes account of the illiquidity of the risk factor or position.

6.3.7 G A *firm* is expected to update data sets to ensure standards of reliability are maintained in accordance with the frequency set out in its VaR model permission, or more frequently if volatility in market prices or rates necessitates more frequent updating. This is in order to ensure a prudent calculation of the VaR measure.

Aggregating VaR measures

6.3.8 G

(1) In determining whether it is appropriate for a *firm* to use empirical correlations within risk categories and across risk categories within a model, the *FCA* expects certain features to be observed in assessing whether such an approach is sound and implemented with integrity. In general, the *FCA* expects a *firm* to determine the aggregate VaR measure by adding the relevant VaR measure for each category, unless the *firm*'s permission provides for a different method of aggregating VaR measures which is empirically sound.

(2) The *FCA* does not expect a *firm* to use the square root of the sum of the squares approach when aggregating measures across risk categories unless the assumption of zero correlation between these categories is empirically justified. If correlations between risk categories are not empirically justified, the VaR measures for each category should simply be added to determine its aggregate VaR measure. However, to the extent that a *firm*'s VaR model permission provides for a different way of aggregating VaR measures:

   (a) that method applies instead; and

   (b) if the correlations between risk categories used for that purpose cease to be empirically justified then the *firm* is expected to notify the *FCA* at once.

Testing prior to model validation

6.3.9 G A *firm* is expected to provide evidence of its ability to comply with the requirements for a VaR model permission. In general, it will be required to demonstrate this by having a back-testing programme in place and should provide three months of back-testing history.

6.3.10 G A period of initial monitoring or live testing is required before a VaR model can be recognised. This will be agreed on a *firm*-by-*firm* basis.

6.3.11 G In assessing the *firm*'s VaR model and risk management, the results of internal model validation procedures used by the *firm* to assess the VaR model will be taken into account.

Back-testing

6.3.12 G For clarity, the back-testing requirements of article 366 of the *EU CRR* (Regulatory back testing and multiplication factors) should be implemented in the manner of IFPRU 6.3.13 G and IFPRU 6.3.14 G.

6.3.13 G If the day on which a loss is made is day n, the value-at-risk measure for that day will be calculated on day n-1, or overnight between day n-1 and day n. Profit and loss figures are produced on day n+1, and back-testing also takes place on day n+1. The *firm*'s supervisor should be notified of any overshootings by close of business on day n+2.

6.3.14 G Any overshooting initially counts for the purpose of the calculation of the plus factor, even if subsequently the *FCA* agrees to exclude it. Thus, where the *firm* experiences an overshooting and already has four or more overshootings for the previous 250 *business days*, changes to the multiplication factor arising from changes to the plus factor become effective at day n+3.

6.3.15 G A longer time period generally improves the power of back-testing. However, a longer time period may not be desirable if the VaR model or market conditions have changed to the extent that historical data is no longer relevant.

6.3.16 G The *FCA*, will review as part of a *firm*'s VaR model permission application, the processes and documentation relating to the derivation of profit and loss used for back-testing. A *firm*'s documentation should clearly set out the basis for cleaning profit and loss. To the extent that certain profit and loss elements are not updated every day (for example, certain reserve calculations) the documentation should clearly set out how such elements are included in the profit and loss series.

Planned changes to the VaR model

6.3.17 G In accordance with article 363(3) of the *EU CRR* (Permission to use internal models), the *FCA* expects a *firm* to provide and discuss with us details of any significant planned changes to the VaR model before those changes are implemented. These details must include detailed information about the nature of the change, including an estimate of the impact on VaR numbers and the incremental risk charge.

Bias from overlapping intervals for 10-day VaR and stressed VaR

6.3.18 G The use of overlapping intervals of 10-day holding periods for article 365 of the *EU CRR* (VaR and stressed VaR calculation) introduces an autocorrelation into the data that would not exist should truly independent 10-day periods be used. This may give rise to an under-estimation of the volatility and the VaR at the 99% confidence level. To obtain clarity on the materiality of the bias, a *firm* should measure the bias arising from the use of overlapping intervals for 10-day VaR and stressed VaR when compared to using independent intervals. A report on the analysis, including a proposal for a multiplier on VaR and stressed VaR to adjust for the bias, should be submitted to the *FCA* for review and approval.

6

Stressed VaR calculation

6.3.19 G Article 365 of the *EU CRR* requires a *firm* that uses an internal model for calculating its *own funds requirement* to calculate, at least weekly, a stressed VaR (sVaR) of their current portfolio. When the *FCA* considers a *firm*'s application to use a sVaR internal model it would expect the features in IFPRU 6.3.20 G to IFPRU 6.3.24 G to be present prior to permission being granted, as indicative that the conditions for granting permission have been met.

Quantile estimator

6.3.20 G The *firm* should calculate the sVaR measure to be greater than or equal to the average of the 2nd and 3rd worst loss in a 12-month time series comprising of 250 observations. The *FCA* expects, as a minimum, that a corresponding linear weighting scheme should be applied if the *firm* uses a larger number of observations.

Meaning of 'period of significant financial stress relevant to the institution's portfolio'

6.3.21 G The *firm* should ensure that the sVaR period chosen is equivalent to the period that would maximise VaR, given the *firm*'s portfolio. There is an expectation that a stressed period should be identified at each legal entity level at which capital is reported. Therefore, group level sVaR measures should be based on a period that maximises the group level VaR, whereas entity level sVaR should be based on a period that maximises VaR for that entity.

Antithetic data

6.3.22 G The *firm* should consider whether the use of antithetic data in the calculation of the sVaR measure is appropriate to the *firm*'s portfolio. A justification for using or not using antithetic data should be provided to the *FCA*.

Absolute and relative shifts

6.3.23 G The *firm* should explain the rationale for the choice of absolute or relative shifts for both VaR and sVaR methodologies. In particular, statistical processes driving the risk factor changes need to be evidenced for both VaR and sVaR.

6.3.24 G The following information is expected to be submitted quarterly:

(1) analysis to support the equivalence of the *firm*'s current approach to a VaR-maximising approach on an ongoing basis;

(2) the rationale behind the selection of key major risk factors used to find the period of significant financial stress;

(3) summary of ongoing internal monitoring of stressed period selection with respect to current portfolio;

(4) analysis to support capital equivalence of upscaled 1-day VaR and sVaR measures to corresponding full 10-day VaR and sVaR measures;

(5) graphed history of sVaR/VaR ratio;

(6) analysis to demonstrate accuracy of partial revaluation approaches specifically for sVaR purposes (for *firms* using revaluation ladders or spot/vol-matrices), which should include a review of the ladders/ matrices or spot/vol-matrices, ensuring that they are extended to include wider shocks to risk factors that incur in stress scenarios; and

(7) minutes of risk committee meeting or other form of evidence to reflect governance and senior management oversight of stressed VaR methodology.

Requirement to have an internal IRC model

6.3.25 G Article 372 of the *EU CRR* (Requirement to have an internal IRC model) requires a *firm* that use an internal model for calculating *own funds requirements* for specific risk of traded debt instruments to also have an internal incremental default and migration risk (IRC) model in place to capture the default and migration risk of its *trading book* positions that are incremental to the risks captured by its VaR model. When the *FCA* considers a *firm*'s application to use an IRC internal model, it expects that the matters in IFPRU 6.3.26 G to IFPRU 6.3.28 G will be included as demonstrating compliance with the standards in article 372.

Basis risks for migration

6.3.26 G The *FCA* expects the IRC model to capitalise pre-default basis risk. In this respect, the model should reflect that in periods of stress the basis could widen substantially. The *firm* should disclose to the *FCA* its material basis risks that are incremental to those already captured in existing market risk capital measures (VaR-based and others). This must take actual close-out periods during periods of illiquidity into account.

Price/spread change model

6.3.27 G The price/spread change model used to capture the profit and loss impact of migration should calibrate spread changes to long-term averages of differences between spreads for relevant ratings. These should either be conditioned on actual rating events, or using the entire history of spreads regardless of migration. Point-in-time estimates are not considered acceptable, unless they can be shown to be as conservative as using long-term averages.

Dependence of the recovery rate on the economic cycle

6.3.28 G To achieve a soundness standard comparable to those under the IRB approach, LGD estimates should reflect the economic cycle. Therefore, the *FCA* expects a *firm* to incorporate dependence of the recovery rate on the economic cycle into the IRC model. Should the *firm* use a conservative parameterisation to comply with the IRB standard of the use of downturn estimates, evidence of this should be submitted in quarterly reporting to the *FCA*, bearing in mind that for trading portfolios, which contain long and short positions, downturn estimates would not in all cases be a conservative choice.

Chapter 7

Liquidity

7

7.1 Application

7.1.1 R ■ IFPRU 7 applies to an *IFPRU investment firm*.

Purpose

7.1.2 G This section contains *rules* that exercise the discretion afforded to the *FCA* as *competent authority* under article 6(4) of the *EU CRR* (Exemption for certain investment firms).

Application of BIPRU 12 (Liquidity standards)

7.1.3 G The *FCA*'s liquidity regime and liquidity reporting in ■ BIPRU 12 (Liquidity standards) and ■ SUP 16 (Reporting requirements) continue to apply to an *IFPRU investment firm* until the liquidity coverage requirement in article 412 of the *EU CRR* becomes applicable in 2015.

7.1.4 G Pending specification of a uniform definition under article 460 of the *EU CRR* (Liquidity) of high and extremely high liquidity and credit quality, a *firm* should be guided by ■ BIPRU 12 (Liquidity standards) when complying with article 416 of the *EU CRR* (Reporting on liquid assets).

Exemption from Part Six of EU CRR on individual basis

7.1.5 R For the purpose of article 6(4) of the *EU CRR*, a *firm* is exempt from compliance with the obligations in Part Six of the *EU CRR* (Liquidity) on an individual basis unless it meets both the following conditions:

(1) it is an *ILAS BIPRU firm*; and

(2) it is a *significant IFPRU firm*.

Exemption from Part Six of EU CRR on consolidated basis

7.1.6 R For the purpose of article 11(3) of the *EU CRR*, a *FCA consolidation group* that meets the condition in ■ IFPRU 7.1.7 R is exempt from compliance with the obligations in Part Six of the *EU CRR* (Liquidity) on a *consolidated basis*.

7.1.7 R The members of the *FCA consolidation group* comprise only *firms* that are exempt under ■ IFPRU 7.1.5 R.

Chapter 8

Prudential consolidation and large exposures

8.1 Prudential consolidation

Application

8.1.1 R (1) This section applies to an *IFPRU investment firm*.

(2) This section does not apply to an *exempt IFPRU commodities firm* if the conditions in (2) are met.

(3) The conditions are:

(a) article 498 of the *EU CRR* (Exemptions for commodities dealers) applies to it;

(b) the *exempt IFPRU commodities firm* is not a member of a *FCA* consolidation group or *non-EEA sub-group*;

(c) each *investment firm* in the group that the *exempt IFPRU commodities firm* belongs to meets the conditions in article 498 of the *EU CRR*; and

(d) any *investment firm* in the group that the *exempt IFPRU commodities firm* belongs to whose head office is outside the *EEA* would have been a *firm* to whom article 498 would have applied if its head office had been in an *EEA State*.

Purpose

8.1.2 G This section contains:

(1) *rules* that exercise the discretion afforded to the *FCA* as *competent authority* under article 18 of the *EU CRR* (Methods of prudential consolidation); and

(2) *guidance* on the criteria that the *FCA* will take into account when considering whether to grant a permission to a *firm* on a case-by-case basis for the individual consolidation method under article 9 of the *EU CRR* (Individual consolidation method).

Methods of prudential consolidation: proportional consolidation

8.1.3 R (1) In carrying out the calculations for the purposes of Part One, Title II, Chapter 2 of the *EU CRR* (Prudential consolidation), a *firm* must include the relevant proportion of an *undertaking* with whom it has:

(a) a *consolidation Article 12(1) relationship*; or

(b) an *article 18(6) relationship*.

(2) In (1), the relevant proportion is such proportion (if any) as stated in a *requirement* imposed on the *firm*.

[**Note**: article 18(3) and (6) of the *EU CRR*]

8.1.4 R In carrying out the calculations for the purposes of Part One, Title II, Chapter 2 of the *EU CRR* (Prudential consolidation), a *firm* (for whom the *FCA* is the *consolidating supervisor*) must include the proportion according to the share of capital held of *participations* in *institutions* and *financial institutions* managed by an *undertaking* included in the consolidation together with one or more *undertakings* not included in the consolidation, where those *undertakings*' liability is limited to the share of capital they hold.

[**Note**: article 18(4) of the *EU CRR*]

8.1.5 R In carrying out the calculations for the purposes of Part One, Title II, Chapter 2 of the *EU CRR* (Prudential consolidation), a *firm* (for whom the *FCA* is the *consolidating supervisor*) must carry out a full consolidation of any *undertaking* with whom it has an *article 18(5) relationship*.

[**Note**: article 18(5) of the *EU CRR*]

Individual consolidation method

8.1.6 G Article 9(2) of the *EU CRR* (Individual consolidation method) requires a *firm*, which is a parent institution, to demonstrate fully to the *FCA*, as *competent authority*, that there are no material practical or legal impediments to the prompt transfer of *own funds* of the *subsidiary* referred to in article 9(1) of the *EU CRR*, or repayment of liabilities when due by that *subsidiary* to the *firm*.

8.1.7 G The *FCA* will assess an application for individual consolidation against articles 9 and 396(2) (Compliance with large exposure requirements) of the *EU CRR* on a case-by-case basis. The *FCA* will assess whether it is still appropriate to permit the treatment if doing so risks conflict with its statutory objectives. The *FCA* will apply a high level of scrutiny to applications under article 9 of the *EU CRR*, consistent with the previous solo consolidation regime.

Application of criteria for individual consolidation method

8.1.8 G When making its assessment, the *FCA* will consider whether any minority interest may represent an impediment of any kind to the prompt transfer of *own funds* or repayment of liabilities from the *subsidiary* to the *parent undertaking*. To reassure the *FCA*, the parent institution should demonstrate that any minority interest in a *subsidiary* will not result in the potential blocking or delay of prompt transfer of *own funds* or repayment of liabilities. Therefore, it may be possible for a *firm* to meet the condition in article 7(1)(d) of the *EU CRR* but not meet the condition in article 9(2).

8.1.9 G The *FCA* will consider the non-exhaustive criteria below when determining whether the condition in article 9(2) of the *EU CRR* is met:

(1) the speed with which funds can be transferred or liabilities repaid to the *firm* and the simplicity of the method for the transfer or repayment;

(2) whether there are any interests other than those of the *firm* in the *subsidiary* and what impact those other interests may have on the *firm*'s control over the *subsidiary* and the ability of the *firm* to require a transfer of funds or repayment of liabilities. As part of the *FCA*'s overall assessment, it would consider ownership of 75% or more of the *subsidiary* as one of the indicators that prompt transfer of *own funds* is likely to be achieved;

(3) whether the prompt transfer of funds or repayment of liabilities to the *firm* might harm the reputation of the *firm* or its *subsidiary*;

(4) whether there are any tax disadvantages for the *firm* or the *subsidiary* as a result of the transfer of funds or repayment of liabilities;

(5) whether there are any exchange controls that may have an impact on the transfer of funds or repayment of liabilities;

(6) whether there are assets in the *subsidiary* available either to be transferred or liquidated for the purposes of the transfer of funds or repayment of liabilities;

(7) whether any regulatory requirements impact on the ability of the *subsidiary* to transfer funds or repay liabilities promptly;

(8) whether the purpose of the *subsidiary* prejudices the prompt transfer of funds or repayment of liabilities;

(9) whether the legal structure of the *subsidiary* prejudices the prompt transfer of funds or repayment of liabilities;

(10) whether the contractual relationships of the *subsidiary* with the *firm* and other third parties prejudices the prompt transfer of funds or repayment of liabilities;

(11) whether past and proposed flows of funds between the *subsidiary* and the *firm* demonstrate the ability to make prompt transfer of funds or repayment of liabilities; and

(12) whether the degree of individual consolidation by the *firm* undermines the *FCA's* ability to assess the soundness of the *firm* as a legal entity (taking into account any other *subsidiary* to which the individual consolidation method under article 9(1) of the *EU CRR* is being applied).

Entities excluded from the scope of prudential consolidation

8.1.10 G The *FCA* will assess applications to exclude entities from the scope of prudential consolidation against article 19(2) of the *EU CRR* on a case-by-case basis. The *FCA* will only grant this treatment with respect to undertakings where one of the conditions in article 19(2) is met. The *FCA* will still make a judgement as to whether it is appropriate to grant this treatment even where one of the conditions in article 19(2) is met.

Application of criteria for exclusion

8.1.11 G Article 19(2) of the *EU CRR* allows the consolidating supervisor to decide in the following cases that an *institution*, *financial institution* or *ancillary services undertaking* which is a *subsidiary* or in which a *participation* is held need not be included in the consolidation in the following cases:

(1) where the *undertaking* concerned is situated in a third country where there are legal impediments to the transfer of necessary information;

(2) where the *undertaking* concerned is of negligible interest only with respect to the objectives of monitoring *institutions*;

(3) where, in the opinion of the *competent authorities* responsible for exercising supervision on a consolidated basis, the consolidation of the financial situation of the *undertaking* concerned would be inappropriate or misleading as far as the objectives of the supervision of *credit institutions* are concerned.

8.1.12 G If several *undertakings* meet the criteria in IFPRU 8.1.11 G (2) and are collectively of non-negligible interest with respect to the specified objectives, the *FCA* will not agree to exclude them all from the consolidation.

8.1.13 G The *FCA* may request a *firm* to provide information about the *undertakings* excluded from consolidation.

Core UK groups

8.1.14 G Article 113(6) of the *EU CRR* (Intra-group credit risk exemption) permits a *firm*, subject to conditions, to apply a 0% risk-weighting for *exposures* to certain entities within its *FCA* consolidation group, namely its *parent undertaking*, its own *subsidiaries* and *subsidiaries* of its *parent undertaking*. Article 400(1)(f) of the *EU CRR* then fully exempts such *exposures* from the *large exposures* limit stipulated in article 395(1) of the *EU CRR* (Limits to large exposures).

8.1.15 G The *FCA* will assess *core UK group* applications against article 113(6) on a case-by-case basis. The *FCA* expects to approve this treatment for *core UK group undertakings* if the conditions stipulated in article 113(6) are met. A *firm* should note that the *FCA* will still make a wider judgement whether it is appropriate to grant this treatment even where the conditions in article 113(6) are met. It is the *FCA's* intention to continue to apply a high level of scrutiny to applications under this article.

8.1.16 G In relation to article 113(6)(d), the *FCA* expects the condition to be satisfied if the counterparty is:

(1) incorporated in the *UK*; or

(2) an *undertaking* of a type that falls within the scope of the Council Regulation of 29 May 2000 on insolvency proceedings (Regulation 1346/2000/EC) and it is established in the *UK* other than by incorporation, and if the *firm* can demonstrate that the

counterparty's centre of main interests is situated in the *UK* within the meaning of that Regulation.

8.1.17 G In relation to article 113(6)(e), the *FCA* will consider the following non-exhaustive criteria when assessing whether this condition has been met:

(1) the speed with which funds can be transferred or liabilities repaid to the *firm* and the simplicity of the method for the transfer or repayment. As part of the FCA's overall assessment, it would consider ownership of 100% of the *subsidiary* as one of the indicators that prompt transfer of *own funds* is likely to be achieved;

(2) whether there are any interests other than those of the *firm* in undertaking and what impact those other interests may have on the *firm*'s control over the *undertaking* and the ability of the *firm* to require a transfer of funds or repayment of liabilities;

(3) whether there are any tax disadvantages for the *firm* or the counterparty as a result of the transfer of funds or repayment of liabilities;

(4) whether the purpose of the *undertaking* prejudices the prompt transfer of funds or repayment of liabilities;

(5) whether the legal structure of the *undertaking* prejudices the prompt transfer of funds or repayment of liabilities;

(6) whether the contractual relationships of the *undertaking* with the *firm* and other third parties prejudices the prompt transfer of funds or repayment of liabilities; and

(7) whether past and proposed flows of funds between the *undertaking* and the *firm* demonstrate the ability to make prompt transfer of funds or repayment of liabilities.

8.1.18 G For the purpose of article 113(6)(e) of the *EU CRR*, for an *undertaking* that is a *firm*, the requirement for the prompt transfer of funds refers to *own funds* in excess of the capital and financial resources requirements to which it is subject under the *regulatory system*.

8.1.19 G When demonstrating how article 113(6)(e) of the *EU CRR* is met, the *FCA* considers that, for a counterparty which is not a *firm*, the application should include a legally binding agreement between the *firm* and the counterparty. This agreement will be to promptly, on demand, by the *firm* increase the *firm's own funds* by an amount required to ensure that the *firm* complies with the provisions contained in Part Two of the *EU CRR* (Own funds) and any other requirements relating to capital resources concentration risk imposed on the *firm* by, or under, the *regulatory system*.

8.1.20 G For the purpose of article 113(6)(e), the *FCA* considers that the agreement to increase the *firm's own funds* may be limited to capital resources available to the *undertaking* and may reasonably exclude such amount of capital resources that, if transferred to the *firm*, would cause the *undertaking* to become balance sheet insolvent in the manner contemplated in section 123(2) of the Insolvency Act 1986.

8.1.21 G The *FCA* will expect a *firm* to which this section applies not to use any member of its *core UK group* (which is not a *firm*) to route lending or to have exposures to any third party in excess of the limits stipulated in article 395(1) of the *EU CRR* (Limits to large exposures).

8.2 Large Exposures

Application

8.2.1 R This section applies to an *IFPRU investment firm*, unless it is an *exempt IFPRU commodities firm* to which article 493 of the *EU CRR* applies.

8.2.2 R This section does not apply to a *FCA* consolidation group on the basis of its *consolidated situation* if the *group* only contains *limited activity firms* or *limited licence firms*.

8

Purpose

8.2.3 G This section contains the *rules* that exercise the discretion afforded to the *FCA* as *competent authority* under article 400(2)(c) and (3) of the *EU CRR* (Large exposures: exemptions). The *FCA* does not intend to exercise its discretion for any of the other exemptions in article 400(2).

Intra-group exposures: non-core large exposures group

8.2.4 G Article 400(2) of the *EU CRR* permits the *FCA* to fully or partially exempt *exposures* incurred by a *firm* to intra-group *undertakings* that meet the specified criteria from the limit stipulated in article 395(1) of the *EU CRR* in relation to a *firm's group of connected clients* that represent its wider group. The *FCA* will consider exempting non-*trading book* and *trading book exposures* to intra-group *undertakings* if specified conditions throughout IFPRU 8.2 are met.

8.2.5 G The *FCA* expects that applications for exemptions under article 400(2)(c) of the *EU CRR* will be for *firms* established in the *UK* where the intra-group *undertakings* to which they have *exposures* meet the criteria for the *core UK group* in article 113(6) of the *EU CRR*, except for article 113(6)(d) (established in the same *EEA State* as the *firm*).

8.2.6 R A *firm* with a *non-core large exposures group permission* may (in line with that permission) exempt, from the application of article 395(1) of the *EU CRR* (Limits to large exposures), *exposures*, including *participations* or other kinds of holdings, incurred by a *firm* to:

(1) its *parent undertaking*; or

(2) other *subsidiary undertakings* of that *parent undertaking*; or

(3) its own *subsidiary undertakings*;

in so far as those *undertakings* are covered by the supervision on a *consolidated basis* to which the *firm* itself is subject, in accordance with the *EU CRR*, Directive 2002/87/EC regarding the supplementary supervision of financial entities in a *financial conglomerate* or with equivalent standards in force in a *third country*; *exposures* that do not meet these criteria, whether or not exempted from article 395(1), shall be treated as *exposures* to a third party.

[**Note**: article 400(2) of the *EU CRR*]

8.2.7 R A *firm* may only make use of the non-core large exposure group exemption where the following conditions are met:

(1) the total amount of the non-trading book exposures from the *firm* to its *non-core large exposures group* does not exceed 100% of the *firm's eligible capital*; or

(if the *firm* has a *core UK group permission*) the total amount of non-trading book exposures from its *core UK group* (including the *firm*) to its *non-core large exposures group* does not exceed 100% of the *core UK group eligible capital*;

(2) the total amount of trading book exposures from the *firm* to its *non-core large exposures group* does not exceed 500% of the *firm*'s *eligible capital*; or

(if the *firm* has a *core UK group permission*) the total amount of *trading book exposures* from its *core UK group* (including the *firm*) to its *non-core large exposures group* does not exceed 500% of the *core UK group eligible capital*;

(3) (if the *firm* has a *core UK group permission*) it gives the *FCA* prior written notice if it intends to concentrate its intra-group exposure to a particular member of its *non-core large exposures group* in excess of 25% of *core UK group eligible capital*.

The written notice must contain the following:

(a) an explanation of how the *firm* will ensure that it will still meet the condition in (1) on a continuing basis;

(b) details of the counterparty, the size of the *exposure* and the expected duration of the *exposure*; and

(c) an explanation of the reason for the *exposure*;

(4) if the *firm* stops concentrating its intra-group *exposure* to a particular member of its *non-core large exposures group* in excess of 25% of *core UK group* eligible capital, it gives the *FCA* prior written notice as set out in (3) if it intends to start to do so again; and

(5) the *firm* submits FSA018 under SUP 16.12 (Integrated regulatory reporting) as applicable to it.

[**Note**: article 400(2)(c) of the *EU CRR*]

8

8.2.8 R A *firm* may calculate limits in IFPRU 8.2.7 R after taking into account the effect of *credit risk mitigation* in line with articles 399 to 403 of the *EU CRR*.

Core UK group eligible capital

8.2.9 R For the purposes of the conditions in IFPRU 8.2.7 R, a *firm* must calculate *core UK group eligible capital* in line with the deduction and aggregation method in IFPRU 8.2.10 R.

8.2.10 R

(1) *Core UK group* eligible capital is equal to the sum of the following amounts for each member of the *core UK group* and the *firm* (the sub-group):

(a) for ultimate *parent undertaking* of the sub-group, the amount calculated in line with article 6 of the *EU CRR* (or other prudential requirements that apply);

(b) for any other member of the sub-group, the amount calculated in line with article 6 of the *EU CRR* (or other prudential requirements that apply) less the book value of the sub-group's holdings of capital instruments in that member, to the extent not already deducted in calculations in line with article 6 of the *EU CRR* (or other prudential requirements that apply) for:

(i) the ultimate *parent undertaking* of the sub-group; or

(ii) any other member of the sub-group.

(c) The deduction in (1)(b) must be carried out separately for each type of capital instrument eligible as *own funds*.

8.2.11 G The *FCA* will assess *core UK group* and non-core large exposure group applications against article 400(2)(c) on a case-by-case basis. The *FCA* will only approve this treatment for non-core large exposure group undertakings where the conditions in article 400(2)(c) are met. A *firm* should note that the *FCA* will still make a wider judgement whether it is appropriate to grant this treatment even where the conditions in article 400(2)(c) are met.

Notification

8.2.12 R A *firm* must immediately notify the *FCA* in writing if it becomes aware that any *exposure* that it has treated as exempt under IFPRU 8.2.6 R or any counterparty that it has been treating as a member of its *non-core large exposures group* has ceased to meet the conditions for application of the treatment in this section.

Conditions for exemptions

8.2.13 R A firm may only make use of the exemptions provided in this section where the following conditions are met:

(1) the specific nature of the *exposure*, the counterparty or the relationship between the *firm* and the counterparty eliminate or reduce the risk of the *exposure*; and

(2) any remaining concentration risk can be addressed by other equally effective means, such as the arrangements, processes and mechanisms in article 81 of *CRD* (Concentration risk).

[**Note**: article 400(3) of the *EU CRR*]

Exposures to trustees

8.2.14 G If a *firm* has an *exposure* to a person ('A') when A is acting on his own behalf, and also an *exposure* to A when A acts in his capacity as trustee, custodian or general partner of an investment trust, unit trust, venture capital or other investment fund, pension fund or a similar fund (a "fund"), the *firm* may treat the latter *exposure* as if it was to the fund, unless such a treatment would be misleading.

8.2.15 G When considering whether the treatment described is misleading, factors a *firm* should consider include:

(1) the degree of independence of control of the fund, including the relation of the fund's board and senior management to the *firm* or to other funds or to both;

(2) the terms on which the counterparty, when acting as trustee, is able to satisfy its obligation to the *firm* out of the fund of which it is trustee;

(3) whether the beneficial owners of the fund are connected to the *firm*, or related to other funds managed within the *firm's group*, or both; and

(4) for a counterparty that is connected to the *firm* itself, whether the *exposure* arises from a transaction entered into on an arm's length basis.

8.2.16 G In deciding whether a transaction is at arm's length, the following factors should be taken into account:

(1) the extent to which the person to whom the *firm* has an *exposure* ('A') can influence the *firm's* operations through, for example, the exercise of voting rights;

(2) the management role of A where A is also a director of the *firm*; and

(3) whether the *exposure* would be subject to the *firm's* usual monitoring and recovery procedures if repayment difficulties emerged.

8

Chapter 9

Public disclosure

9.1 Application and Purpose

Application

9.1.1 R IFPRU 9 applies to an *IFPRU investment firm*.

Purpose

9.1.2 G This chapter implements article 90 (Public disclosure on return on assets) of *CRD*.

Public disclosure on return of assets

9.1.3 R A *firm* must disclose in its *annual report and accounts* among the key indicators their return on assets, calculated as their net profit divided by their total balance sheet.

[**Note**: article 90 of *CRD*]

Chapter 10

Capital buffers

10.1 Application

10.1.1 R IFPRU 10 applies to an *IFPRU investment firm*, unless it is one of the following:

(1) an *IFPRU limited licence firm*; or

(2) an *exempt IFPRU commodities firm*.

Purpose

10.1.2 G This chapter implements articles 129 (part), 130 (part), 140 (part), 141, 142 (part) of *CRD*.

10.2 Capital conservation buffer

10.2.1 R A *firm* must calculate a *capital conservation buffer* of *common equity tier 1 capital* equal to 2.5% of its *total risk exposure amount*.

[**Note:** article 129(1) (part) of *CRD*]

10.3 Countercyclical capital buffer

Main requirement

10.3.1 R A *firm* must calculate a *countercyclical capital buffer* of *common equity tier 1 capital* equal to its *total risk exposure amount* multiplied by the weighted average of the *countercyclical buffer rates* that apply to exposures in the jurisdictions where the *firm's relevant credit exposures* are located.

[**Note:** article 130(1) (part) of *CRD*]

Calculation of countercyclical capital buffer rates

10.3.2 R

(1) To calculate the weighted average in IFPRU 10.3.1 R, a *firm* must apply to each applicable *countercyclical buffer rate* its total *own funds requirements* for credit risk, specific risk, incremental default and migration risk that relates to the *relevant credit exposures* in the jurisdiction in question, divided by its total *own funds requirements* for credit risk that relates to all of its *relevant credit exposures*.

(2) For the purposes of (1), a *firm* must calculate its total *own funds requirement* for credit risk, specific risk, incremental default and migration risk in accordance with Part Three, Titles II (Capital requirements for credit risk) and IV (Own funds requirements for market risk) of the *EU CRR*.

(3) The *countercyclical buffer rate* for an exposure located in the *UK* is the rate set by the *UK countercyclical buffer authority* for the *UK*.

(4) The *countercyclical buffer rate* for an exposure located in an *EEA State* other than the *UK* is:

(a) the rate set by the *EEA countercyclical buffer authority* for that jurisdiction; or

(b) if that rate exceeds 2.5% of *total risk exposure amount* and has not been recognised by the *UK countercyclical buffer authority*, 2.5%

(5) The *countercyclical buffer rate* for an exposure located in a *third country* is the rate set by the *UK countercyclical buffer authority* for that jurisdiction.

(6) If the *UK countercyclical buffer authority* has not set a rate for a *third country*, the *countercyclical buffer rate* for an exposure located in that jurisdiction is:

10

(a) the rate set by the *third country countercyclical buffer authority* for that jurisdiction; or

(b) if that rate exceeds 2.5% and has not been recognised by the *UK countercyclical buffer authority*, 2.5%.

(7) If the *UK countercyclical buffer authority* has not set a rate for a *third country* and either there is no *third-country countercyclical buffer authority* for that country or the authority has not set a rate for that jurisdiction, the *countercyclical buffer rate* for an exposure located in that jurisdiction is zero.

(8) If the *countercyclical buffer rate* for the *UK* is increased, that increase takes effect from the date specified by the *UK countercyclical buffer authority*.

(9) If the *countercyclical buffer rate* for an *EEA State* other than the *UK* is increased, subject to (4)(b), that increase takes effect from:

(a) the date specified by the *EEA countercyclical buffer authority* for that jurisdiction, if the rate applied under this chapter does not exceed 2.5%; or

(b) the date specified by the *UK countercyclical buffer authority* if the rate applied under this chapter exceeds 2.5%.

(10) If the *countercyclical buffer rate* for a *third country* is increased by the *UK countercyclical buffer authority*, that increase takes effect from the date specified by the *UK countercyclical buffer authority*.

(11) If the *UK countercyclical buffer authority* does not set a *countercyclical buffer rate* for a *third country* and that rate is increased by the *third-country countercyclical buffer authority* for that jurisdiction, subject to 6(b), that increase takes effect from:

(a) the date 12 months after the date on which the increase was published by the *third-country countercyclical buffer authority* in accordance with the relevant law of the *third country*, if the rate applied under this chapter does not exceed 2.5%; or

(b) the date specified by the *UK countercyclical buffer authority* if the rate applied under this chapter exceeds 2.5%.

(12) If a *countercyclical buffer rate* is reduced, that reduction takes effect immediately.

[**Note:** articles 136(4) (part) , 139(2) to (5) (part) and 140(1) to (4) and (6) (part) of *CRD*]

Location of exposures

10.3.3 G A *firm* must identify the geographical location of a *relevant credit exposure* in accordance with the regulatory technical standards adopted under article 140(7) of *CRD*.

[**Note:** article 140(5) of *CRD*]

10.4 Capital conservation measures

Combined buffer

10.4.1 R A *firm* does not meet the *combined buffer* if the *common equity tier 1 capital* maintained by the *firm* which is not used to meet the *own funds requirement* under article 92(1)(c) of the *EU CRR* (Total capital ratio) does not meet the *combined buffer*.

[**Note:** articles 129(1) (part) and 130(5) (part) of *CRD*]

Restrictions on distributions

10.4.2 R A *firm* that meets the *combined buffer* must not make a *distribution in connection with common equity tier 1 capital* to an extent that would decrease its *common equity tier 1 capital* to a level where the *combined buffer* is no longer met.

[**Note:** article 141(1) of *CRD*]

10.4.3 R

(1) A *firm* that does not meet the *combined buffer* must:

(a) calculate the *MDA* in accordance with (4); and

(b) report the *MDA* to the *FCA* in writing no later than five *business days* after the *firm* identified that it did not meet the *combined buffer*.

(2) A *firm* that does not meet the *combined buffer* must not undertake any of the following actions before it has calculated the *MDA*:

(a) make a *distribution in connection with common equity tier 1 capital*;

(b) create an obligation to pay variable remuneration or *discretionary pension benefits* or pay variable remuneration or *discretionary pension benefits* if the obligation to pay was created at a time when the *firm* did not meet the *combined buffer*; and

(c) make payments on *additional tier 1 instruments*.

(3) If a *firm* does not meet the *combined buffer*, it must not distribute more than the *MDA*, calculated in (4), through any action in (2)(a) to (c).

(4) (a) A *firm* must calculate the *MDA* by multiplying the sum calculated in (5) by the factor determined in (6).

(b) Any of the actions in (2)(a), (b) or (c) shall have the effect of reducing the *MDA*.

(5) The sum to be multiplied in (4) shall consist of:

(a) interim profits not included in *common equity tier 1 capital* under article 26(2) of the *EU CRR* (Common equity tier 1 items) that have been generated since the most recent decision on the distribution of profits or any of the actions in 2(a), (b) or (c);

Plus

(b) year-end profits not included in *common equity tier 1 capital* under article 26(2) of the *EU CRR* that have been generated since the most recent decision on the distribution of profits or any of the actions in (2) (a), (b) or (c);

Minus

(c) amounts which would be payable by tax if the items specified in (a) and (b) were to be retained.

(6) The factor in (4) shall be determined as follows:

(a) if the *common equity tier 1 capital* maintained by the *firm* which is not used to meet the *own funds requirement* under article 92(1)(c) of the *EU CRR* expressed as a percentage of the *firm's total risk exposure amount* is within the first (ie, the lowest) quartile of the *combined buffer*, the factor shall be 0;

(b) if the *common equity tier 1 capital* maintained by the *firm* which is not used to meet the *own funds requirement* under article 92(1)(c) of the *EU CRR*, expressed as a percentage of the *firm's total risk exposure amount* is within the second quartile of the *combined buffer*, the factor shall be 0.2;

(c) if the *common equity tier 1 capital* maintained by the *firm* which is not used to meet the *own funds requirement* under article 92(1)(c) of the *EU CRR* expressed as a percentage of the *firm's total risk exposure amount* is within the third quartile of the *combined buffer*, the factor shall be 0.4;

(d) if the *common equity tier 1 capital* maintained by the *firm* which is not used to meet the *own funds requirement* under article 92(1)(c) of the *EU CRR* expressed as a percentage of the *firm's total risk exposure amount* is within the fourth (ie, the highest) quartile of the *combined buffer*, the factor shall be 0.6.

(7) A *firm* must calculate the lower and upper bounds of each quartile of the *combined buffer* as follows:

$$lower\ bound\ of\ quartile = \frac{Combined\ buffer}{4} \times (Q_n - 1)$$

$$upper\ bound\ of\ quartile = \frac{Combined\ buffer}{4} \times Q_n$$

"Q_n" indicates the ordinal number of the quartile concerned.

(8) The restrictions imposed by this *rule* only apply to payments that result in a reduction of *common equity tier 1 capital* or in a reduction of profits, and where a suspension of payment or failure to pay does not constitute an event of default or a condition for the commencement of proceedings for an order for the appointment of a liquidator or administrator of the *firm*.

(9) If a *firm* does not meet the *combined buffer* and intends to distribute any of its distributable profits or undertake an action in (2)(a), (b) and (c), it must give the *FCA* not less than one *month*'s notice before the intended date of distribution or action. When giving notice a *firm* must provide the following information:

(a) the amount of *own funds* maintained by the *firm*, subdivided as follows:

(i) *common equity tier 1 capital*;

(ii) *additional tier 1 capital*; and

(iii) *tier 2 capital*;

(b) the amount of its interim and year-end profits;

(c) the *MDA* calculated in (4);

(d) the amount of distributable profits it intends to allocate between the following:

(i) dividend payments;

(ii) share buybacks;

(iii) payments on *additional tier 1 instruments*; and

(iv) the payment of variable remuneration or *discretionary pension benefits*, whether by creation of a new obligation to pay, or payment pursuant to an obligation to pay created at a time when the *firm* did not meet its *combined buffer*.

[**Note:** article 141(2) to (9) of *CRD*]

10.5 Capital conservation plan

10.5.1 R When a *firm* does not meet the *combined buffer*, it must prepare a capital conservation plan and submit it to *FCA* no later than five *business days* after the *firm* identified that it did not meet the *combined buffer*.

[**Note:** article 142(1) of *CRD*]

10.5.2 R The capital conservation plan must include the following

(1) the *MDA*;

(2) estimates of income and expenditure and a forecast balance sheet;

(3) measures to increase the capital ratios of the *firm*; and

(4) a plan and timeframe for the increase of *own funds* with the objective of meeting the *combined buffer*.

[**Note:** article 142(2) of *CRD*]

10.6 Application on an individual and consolidated basis

Application on an individual basis

10.6.1 R This chapter applies to a *firm* on an individual basis, whether or not it also applies to the *firm* on a *consolidated basis* or *sub-consolidated basis*.

Application on a consolidated basis

10.6.2 R A *firm* that is a *parent institution in a Member State* must comply with this chapter on the basis of its *consolidated situation*.

10.6.3 R A *firm* controlled by a *parent financial holding company in a Member State* or a *parent mixed financial holding company in a Member State* must comply with this chapter on the basis of the *consolidated situation* of that holding company in the *FCA consolidation group*.

Sub-consolidation of entities in third countries

10.6.4 R A *firm* that is a *subsidiary* must apply this chapter on a *sub-consolidated basis* if the *firm*, or the *parent undertaking* where it is a *financial holding company* or *mixed financial holding company*, have an *institution* or *financial institution* as a *subsidiary* in a *third country* or hold a *participation* in such an *institution* or *financial institution*.

[**Note:** articles 129(1) (part) and 130(1) (part) of *CRD*]

Extent and manner of prudential consolidation

10.6.5 G If this chapter applies to a *firm* on a *consolidated basis* on a *sub-consolidated basis*, the *firm* must carry out consolidation to the extent and in the manner prescribed in Part One, Title II, Chapter 2, Section 2 (Methods for prudential consolidation) and Section 3 (Scope of prudential consolidation) of the *EU CRR* and IFPRU 8.1 (Prudential consolidation).

10.7 Exemption

10.7.1 R This chapter does not apply to a *firm* that meets the condition in IFPRU 10.7.2 R.

[**Note:** articles 129(2) (part) and 130(2) (part) of *CRD*]

10.7.2 R

(1) The condition referred to in IFPRU 10.7.1 R is that the *firm* is a small and medium-sized *investment firm*.

(2) For this purpose, a *firm* is categorised as small and medium-sized in accordance with the European Commission Recommendation 2003/361/EC concerning the definition of micro, small and medium-sized enterprises.

[**Note:** articles 129(4) and 130(4) of *CRD*]

Chapter 11

Recovery and resolution

11.1 Application and purpose

Application

11.1.1 R IFPRU 11 applies to:

(1) an *IFPRU 730k firm* that is not subject to supervision on a *consolidated basis*;

(2) a *firm* that is an *RRD group member*;

(3) a *qualifying parent undertaking* that is an *RRD group member*; and

(4) a *qualifying parent undertaking* that is a *mixed activity holding company* of an *IFPRU 730k firm*.

11.1.2 G (1) An *IFPRU 730k firm* that is not subject to supervision on a *consolidated basis* will not be an *RRD group member*.

(2) An *IFPRU 730k firm* may be subject to supervision on a *consolidated basis* by the *FCA*, the *PRA* or another *competent authority*.

Exclusion of PRA authorised persons and groups

11.1.3 R This chapter does not apply to:

(1) a *PRA authorised person*;

(2) an *RRD group member* that is:

(a) a *qualifying parent undertaking* of a *PRA authorised person*; and

(b) subject to supervision on a *consolidated basis* by the *PRA*; and

(3) a *qualifying parent undertaking* that is a *mixed activity holding company* of a *PRA authorised person*.

Exclusion of non-UK firms

11.1.4 R This chapter does not apply to:

(1) an *incoming firm*; or

(2) a *firm* that is incorporated in, or formed under the law of, a *third country*.

Purpose

11.1.5 G This chapter implements certain provisions of *RRD*.

Guidance on application

11.1.6 G

(1) *RRD* applies to *credit institutions* and to *investments firms* with an *initial capital* requirement of €730,000. Together, these are referred to as *RRD institutions* in our *rules*.

(2) It also applies to *financial institutions*, *financial holding companies* and *mixed financial holding companies* within the same *group* as these *institutions* that are *subsidiaries* of an *EEA parent undertaking*. An *EEA parent undertaking* is an *institution*, a *financial holding company* or a *mixed financial holding company* in the *EEA* that is not itself a *subsidiary* of an *institution*, a *financial holding company* or a *mixed financial holding company* in the *EEA*.

(3) A *group* of these types of *institutions* and *group* members is referred to as an *RRD group* in our *rules* and the members of an *RRD group* are referred to as *RRD group members*.

(4) If the *group* includes a *BIPRU firm* this *firm* will be an *RRD group member* because a *BIPRU firm* is a *financial institution*.

(5) Some parts of *RRD* also apply to *mixed activity holding companies* of *RRD institutions*.

(6) The table in IFPRU 11.1.7 G summarises the application of IFPRU 11.

11.1.7 G The table below summarises whether a section of IFPRU 11 applies to a *firm* or *qualifying parent undertaking*:

	(1) *IFPRU 730k firm* that is not subject to supervision on a *consolidated basis*	(2) *firm* or *qualifying parent undertaking* that is the *EEA parent undertaking* of an *RRD group*	(3) specific application to an *IFPRU 730k firm* that is a *subsidiary* of an *EEA parent undertaking* in another *EEA State* (note 1)	(4) *firm* or *qualifying parent undertaking* that is a *subsidiary* of an *EEA parent undertaking* of an *RRD group*	(5) *qualifying parent undertaking* that is a *mixed activity holding company* of an *IFPRU 730k firm*
IFPRU 11.1 (Application and purpose)	Yes	Yes	No	Yes	Yes
IFPRU 11.2 (Individual recovery plans)	Yes	No	No	No	No
IFPRU 11.3 (Group recovery plans)	No	Yes	Yes	No	No

IFPRU 11.4 (Information for resolution plans)	Yes	Yes	Yes	No	No
IFPRU 11.5 (Intra-group financial support)	No	Yes	Yes - IFPRU 11.5.7 R only	Yes	Yes (note 2)
IFPRU 11.6 (Contractual recognition of bail-in)	Yes	Yes	No	Yes	Yes (note 3)
IFPRU 11.7 (Notifications)	Yes	Yes	No	Yes	Yes

Note 1: IFPRU 11.3.1R (3) and IFPRU 11.4.1R (4) more fully describe this type of *firm*. Where specific application is not provided for this type of *firm*, the application is explained by (4).

Note 2: IFPRU 11.5 only applies to *mixed activity holding companies* of an *IFPRU 730k firm* in an *RRD group*.

Note 3: IFPRU 11.6 only applies to *mixed activity holding companies* that do not hold an *RRD institution* using an intermediate *financial holding company* or *mixed financial holding company.*

11

11.2 Individual recovery plans

Application

11.2.1 R This section applies to an *IFPRU 730k firm* that is not subject to supervision on a *consolidated basis*.

11.2.2 G This section applies differently depending on whether the *firm* is a *significant IFPRU firm* or a non-*significant IFPRU firm* as explained in the table below.

Provisions of IFPRU 11.2	Who it applies to
IFPRU 11.2.4 R to IFPRU 11.2.5 G	All *firms*.
IFPRU 11.2.6 R	*Significant IFPRU firms* only.
IFPRU 11.2.7 R to IFPRU 11.2.8 G	Non-*significant IFPRU firms* only.
IFPRU 11.2.9 G to IFPRU 11.2.17 R	All *firms*.
IFPRU 11.2.18R (1)	*Significant IFPRU firms* only.
IFPRU 11.2.18R (2)	Non-*significant IFPRU firms* only.
IFPRU 11.2.18R (3)	All *firms*.
IFPRU 11.2.19 R	All *firms*.

11.2.3 G IFPRU 1.2 (Significant IFPRU firm) explains the definition of a *significant IFPRU firm*.

Requirement to draw up and maintain a recovery plan

11.2.4 R A *firm* must draw up and maintain a *recovery plan*.

[**Note:** article 5(1) of *RRD*]

11.2.5 G A *recovery plan* is a governance arrangement for the purposes of SYSC 4.1.1 R (General requirements).

Recovery plan for a significant IFPRU firm

11.2.6 R If a *firm* is a *significant IFPRU firm*, its *recovery plan* must include the information in IFPRU 11 Annex 1R (Contents of recovery plans for significant IFPRU firms and group recovery plans for groups that include significant IFPRU firms).

[**Note:** article 5(5) of *RRD*]

11

Recovery plan for a non-significant IFPRU firm

11.2.7 R If a *firm* is not a *significant IFPRU firm* its *recovery plan* must include:

(1) a summary of the key elements of the *recovery plan*;

(2) information on the governance of the *firm*, including:

(a) how the *recovery plan* is integrated into the corporate governance of the *firm*; and

(b) the firm's overall risk management framework;

(3) a description of the legal and financial structures of the *firm*, including:

(a) the *core business lines*; and

(b) critical functions;

(4) recovery options, including:

(a) capital and liquidity actions required to maintain or restore the viability and financial position of the *firm*; and

(b) arrangements and measures to conserve or restore the *firm's own funds*;

(5) an assessment of the expected timeframe for implementing recovery options;

(6) a summary of the overall *recovery capacity* of the *firm*, including:

(a) the risks associated with recovery options;

(b) an analysis of any material impediments to the effective and timely execution of the *recovery plan*; and

(c) whether and how material impediments could be overcome;

(7) a summary of any material changes to the *recovery plan* since the previous version was sent to the *FCA*;

(8) preparatory measures the *firm* has taken or plans to take to help implement the *recovery plan*; and

(9) the measures which the *firm* could take if it has infringed an *RRD early intervention condition* or is likely to infringe one of those conditions in the near future.

[**Note:** articles (4)(1), 5(5) and Annex A of *RRD*]

11.2.8 G A *firm* should include additional information from IFPRU 11 Annex 1R (Recovery plans for significant IFPRU firms and group recovery plans for groups that include significant IFPRU firms) in its *recovery plan* where this information is material to its business.

[**Note:** article 5(5) of *RRD*]

11.2.8A G The *FCA* may require a *firm* to include the additional information referred to in IFPRU 11.2.8G in its *recovery plan* using its power under section 55L of the *Act*.

[**Note:** article 4(3) of *RRD*]

11

Recovery options

11.2.9 G

(1) When identifying recovery options, a *firm* should consider a range of scenarios of severe macroeconomic and financial stress relevant to the *firm*'s specific conditions.

(2) The range of scenarios should include system-wide events and stress specific to individual legal persons and *groups*.

[**Note:** article 5(6) of *RRD*]

Extraordinary public financial support

11.2.10 R

A *firm* must not assume any access to, or receipt of, *extraordinary public financial support* in its *recovery plan*.

[**Note:** article 5(3) of *RRD*]

Use of central bank facilities

11.2.11 R

If the *recovery plan* includes the use of central bank facilities, the *firm* must:

(1) include an analysis of how and when the *firm* may apply for the use of central bank facilities; and

(2) identify those assets which would be expected to qualify as collateral.

[**Note:** article 5(4) of *RRD*]

Recovery plan indicators

11.2.12 R

A *firm* must:

(1) include a framework of indicators in its *recovery plan* which identify when it may take appropriate actions in the plan;

(2) ensure the *recovery plan* indicators can be monitored easily; and

(3) have arrangements to monitor the *recovery plan* indicators regularly.

11.2.13 G

The *recovery plan* indicators may relate to the *firm*'s financial position and may be of a qualitative or a quantitative nature.

11.2.14 R

A *firm* must notify the *FCA* without delay of a decision to take an action referred to in its *recovery plan*, whether or not the relevant indicator has been met.

11.2.15 R

A *firm* must notify the *FCA* without delay of a decision not to take an action referred to in its *recovery plan* where the relevant indicator has been met.

[**Note:** article 9(1) of *RRD*]

Assessment and review by the management body

11.2.16 R A *firm* must ensure its *management body* assesses and approves the *recovery plan* before sending it to the *FCA*.

[**Note:** article 5(9) of *RRD*]

11.2.17 R A *firm* must demonstrate to the *FCA* that:

(1) carrying out its *recovery plan* is reasonably likely to maintain or restore the viability and financial position of the *firm*, taking into account the preparatory measures that the *firm* has taken, or plans to take; and

(2) its *recovery plan*:

(a) is reasonably likely to be carried out quickly and effectively in situations of financial stress; and

(b) avoids, to the maximum extent possible, any significant adverse effect on the financial system, including in scenarios which would lead other *RRD institutions* to implement *recovery plans* and *group recovery plans* at the same time.

[**Note:** article 6(1) of *RRD*]

Updating and submission of recovery plans

11.2.18 R (1) A *significant IFPRU firm* must update its *recovery plan* at least annually.

(2) A *firm* that is not a *significant IFPRU firm* must update its *recovery plan* at least once every two years.

(3) A *firm* must also update its *recovery plan* after a change to any of the following which could materially affect its *recovery plan*:

(a) its legal or organisational structure;

(b) its business; or

(c) its financial situation.

[**Note:** articles 4(1)(b) and 5(2) *RRD*]

11.2.19 R A *firm* must send its *recovery plan* to the *FCA* in line with SUP 16.20 (Recovery plans and information for resolution plans).

[**Note:** article 6(1) of *RRD*]

11.3 Group recovery plans

Application

11.3.1 R This section applies to:

(1) a *firm* that is the *EEA parent undertaking* of an *RRD group*;

(2) a *qualifying parent undertaking* that is the *EEA parent undertaking* of an *RRD group*; and

(3) an *IFPRU 730k firm* that is the *subsidiary* of the *EEA parent undertaking* of an *RRD group* where:

(a) the *EEA parent undertaking* is an *EEA parent financial holding company* or an *EEA parent mixed financial holding company* that is incorporated in, or formed under, the law of an *EEA state* other than the *United Kingdom*; and

(b) the *IFPRU 730k firm* has the *FCA* as its *consolidating supervisor*.

11.3.2 G This section applies differently depending on whether the *group* includes a *significant IFPRU firm* or a non-*significant IFPRU firm*, as explained in the table below.

Provisions of IFPRU 11.3	Who it applies to
IFPRU 11.3.4 R to IFPRU 11.3.7 R	All *groups*.
IFPRU 11.3.8 R	*Groups* that include an *IFPRU 730k firm* that is a *significant IFPRU firm* and *groups* that do not include an *IFPRU 730k firm* only.
IFPRU 11.3.9 R to IFPRU 11.3.10 G	Non-*significant IFPRU firm groups* only.
IFPRU 11.3.11 G to IFPRU 11.3.19 R	All *groups*.
IFPRU 11.3.20R (1)(a)	*Groups* that include an *IFPRU 730k firm* that is a *significant IFPRU firm* and *groups* that do not include an *IFPRU 730k firm* only.
IFPRU 11.3.20R (1)(b)	Non-*significant IFPRU firm groups* only.
IFPRU 11.3.20R (2)	All *groups*.
IFPRU 11.3.21 R	All *groups*.

11.3.3 G ■ IFPRU 1.2 (Significant IFPRU firm) explains the definition of a *significant IFPRU firm*.

Requirement to draw up and maintain a group recovery plan

11.3.4 R A *firm* or *qualifying parent undertaking* must draw up and maintain a *group recovery plan*.

[**Note:** article 7(1) of *RRD*]

General requirements of the group recovery plan

11.3.5 R The *group recovery plan* must:

(1) consist of a plan for the recovery of the *RRD group* as a whole; and

(2) identify measures the *group* may need to implement at the level of:

(a) the *EEA parent undertaking*; and

(b) each individual *subsidiary*.

[**Note:** article 7(1) of *RRD*]

11.3.6 R The *group recovery plan* must include arrangements to ensure the coordination and consistency of measures for each *RRD group member*, including, where applicable, each *significant branch*.

[**Note:** article 7(4) of *RRD*]

11.3.7 R The *group recovery plan* must:

(1) aim to stabilise the *RRD group* as a whole and each *RRD institution* in the *group*, when the *group*, or any *RRD institution* in the *group*, is under financial stress;

(2) aim to address or remove the causes of the financial stress and restore the financial position of the *group* or the *RRD institution* in question; and

(3) at the same time consider the financial position of other *group* members.

[**Note:** article 7(4) of *RRD*]

Group recovery plan for a group that includes an IFPRU 730k firm that is a significant IFPRU firm or does not include an IFPRU 730k firm

11.3.8 R The *group recovery plan* must include the information in IFPRU 11 Annex 1R (Recovery plans for significant IFPRU firms and group recovery plans for groups that include significant IFPRU firms) if the *RRD group*:

(1) includes an *IFPRU 730k firm* that is a *significant IFPRU firm*; or

(2) does not include an *IFPRU 730k firm*.

[**Note:** articles 5(5) and 7(5) of *RRD*]

Group recovery plan for a group that includes an IFPRU 730k firm that is not a significant IFPRU firm

11.3.9 **R** If the *RRD group* includes an *IFPRU 730k firm* that is not a *significant IFPRU firm* (and does not include an *IFPRU 730k firm* that is a *significant IFPRU firm*) the *group recovery plan* must include:

(1) a summary of the key elements of the *group recovery plan*;

(2) information on the governance of the *group*, including:

(a) how the *group recovery plan* is integrated into the corporate governance of the *group*; and

(b) the *group*'s overall risk management framework;

(3) a description of the legal and financial structures of the *group* members covered by the plan, including:

(a) the *core business lines*; and

(b) critical functions;

(4) recovery options, including:

(a) capital and liquidity actions required to maintain or restore the viability and financial position of the *group*; and

(b) arrangements and measures to conserve or restore the *own funds* of each *RRD institution* in the *group* on an *individual* and a *consolidated basis*;

(5) an assessment of the expected timeframe for implementing recovery options;

(6) a summary of the overall capability of the *group* to restore its financial position following a significant deterioration, including:

(a) the risks associated with recovery options;

(b) an analysis of any material impediments to the effective and timely execution of the *group recovery plan*; and;

(c) whether and how those impediments could be overcome;

(7) a summary of any material changes to the *group recovery plan* since the previous version was sent to the *FCA* or other *EEA consolidating supervisor*;

(8) preparatory measures the *group* has taken, or plans to take, to help implement the *group recovery plan*; and

(9) the measures which the *group* could take if any *RRD institution* in the *group* infringes an *RRD early intervention condition* or is likely to infringe one of those conditions in the near future.

[**Note:** articles (4)(1), 5(5), 7(5) and Annex A of *RRD*]

11.3.10 **G** A *firm* or *qualifying parent undertaking* should include additional information from IFPRU 11 Annex 1R (Recovery plans for significant IFPRU firms and group recovery plans for groups that include significant IFPRU

11

firms) in its *group recovery plan* where this information is material to the business of the *group*.

[**Note:** article 5(5) of *RRD*]

11.3.10A G The *FCA* may require a *firm* or *qualifying parent undertaking* to include the additional information referred to in IFPRU 11.3.10G in its *group recovery plan* by using its power under:

(1) section 55L of the *Act* to require a *firm*; or

(2) section 192C of the *Act* to direct a *qualifying parent undertaking*.

[**Note:** article 4(3) of *RRD*]

Recovery options

11.3.11 G (1) When identifying recovery options, a *firm* or *qualifying parent undertaking* should consider a range of scenarios of severe macroeconomic and financial stress relevant to the *group*'s specific conditions.

(2) The range of scenarios should include system-wide events and stress specific to individual legal persons and *groups*.

(3) For each of the scenarios in (1), a *group recovery plan* should identify whether there are:

(a) obstacles to implementing recovery measures within the *group*, including at the level of individual members covered by the plan; and

(b) substantial practical or legal impediments to the prompt transfer of *own funds* or the repayment of liabilities or assets within the *group*.

[**Note:** articles 5(6) and 7(6) of *RRD*]

Extraordinary public financial support

11.3.12 R A *firm* or *qualifying parent undertaking* must not assume any access to, or receipt of, *extraordinary public financial support* in its *group recovery plan*.

[**Note:** articles 5(3) and 7(5) of *RRD*]

Use of central bank facilities

11.3.13 R If the *group recovery plan* includes the use of central bank facilities, the *firm* or *qualifying parent undertaking* must:

(1) include an analysis of how and when members of the *group* may apply for the use of central bank facilities; and

(2) identify those assets which would be expected to qualify as collateral.

[**Note:** articles 5(4) and 7(5) of *RRD*]

Group recovery plan indicators

11.3.14 R A *firm* or *qualifying parent undertaking* must:

(1) include a framework of indicators in its *group recovery plan* which identify when it, or another *group* member, may take appropriate actions in the plan;

(2) ensure the *group recovery plan* indicators can be monitored easily; and

(3) have arrangements to monitor the *group recovery plan* indicators regularly.

11.3.15 G The *group recovery plan* indicators may relate to the *group*'s financial position and may be of a qualitative or a quantitative nature.

11.3.16 R A *firm* or *qualifying parent undertaking* must notify the *FCA* without delay of a decision to take an action referred to in its *recovery plan*, whether or not the relevant indicator has been met.

11.3.17 R A *firm* or *qualifying parent undertaking* must notify the *FCA* without delay of a decision not to take an action referred to in the *group recovery plan* where the relevant indicator has been met.

[**Note:** article 9(1) of *RRD*]

Assessment and review by the management body of the EEA parent undertaking

11.3.18 R (1) A *firm* that is an *EEA parent undertaking* or a *qualifying parent undertaking* must ensure that its management body assesses and approves the *group recovery plan* before sending it to its *consolidating supervisor.*

(2) An *IFPRU 730k firm* that is not an *EEA parent undertaking* must ensure the management body of its *EEA parent undertaking* assesses and approves the *group recovery plan* before the *IFPRU 730k firm* sends it to its *consolidating supervisor.*

[**Note:** article 7(7) of *RRD*]

11.3.19 R A *firm* or *qualifying parent undertaking* must demonstrate to its *consolidating supervisor* that:

(1) carrying out its *group recovery plan* is reasonably likely to maintain or restore the viability and financial position of *RRD institutions* in the *group*, taking into account the preparatory measures that the *group* has taken, or plans to take; and

(2) its *group recovery plan*:

(a) is reasonably likely to be carried out quickly and effectively in situations of financial stress; and

(b) avoids, to the maximum extent possible, any significant adverse effect on the financial system, including in scenarios which would lead other *RRD institutions* to implement *recovery plans* and *group recovery plans* at the same time.

[**Note:** article 6(1) of *RRD*]

Updating and submission of group recovery plans

11.3.20 R (1) A *firm* or *qualifying parent undertaking* must update the *group recovery plan* at least:

(a) annually, if the *group*:

(i) includes an *IFPRU 730k firm* that is a *significant IFPRU firm*; or

(ii) does not include an *IFPRU 730k firm*; or

(b) once every two years, if the *group* includes an *IFPRU 730k firm* that is not a *significant IFPRU firm*.

(2) A *firm* or *qualifying parent undertaking* must also update its *group recovery plan* after a change to any of the following which could materially affect the *group recovery plan*:

(a) its legal or organisational structure;

(b) its business; or

(c) its financial situation.

[**Note:** articles 4(1)(b), 5(2) and 7(5) of *RRD*]

11

11.3.21 R (1) A *firm* or *qualifying parent undertaking* must send the *group recovery plan* to its *EEA consolidating supervisor.*

(2) Where the *consolidating supervisor* is the *FCA*, a *firm* or *qualifying parent undertaking* must send the *group recovery plan* in line with ■ SUP 16.20 (Recovery plans and information for resolution plans).

[**Note:** articles 6(1) and 7(1) of *RRD*]

11.4 Information for resolution plans

Application

11.4.1 R This section applies to:

(1) an *IFPRU 730k firm* that is not subject to supervision on a *consolidated basis*;

(2) a *firm* that is the *EEA parent undertaking* of an *RRD group*;

(3) a *qualifying parent undertaking* that is the *EEA parent undertaking* of an *RRD group*; and

(4) an *IFPRU 730k firm* that is the *subsidiary* of the *EEA parent undertaking* of an *RRD group*:

(a) where the *EEA parent undertaking* is an *EEA parent financial holding company* or an *EEA parent mixed financial holding company* that is incorporated in, or formed under, the law of an *EEA state* other than the *United Kingdom*; and

(b) the *IFPRU 730k firm* has the *FCA* as its *consolidating supervisor.*

11.4.2 R This section only applies if the Bank of England is the *resolution authority* of the *firm* or *group*.

Submission of resolution plan information

11.4.3 R A *firm* or *qualifying parent undertaking* must send the information in IFPRU 11 Annex 2R (Resolution plan information) to the *FCA* in line with SUP 16.20 (Recovery plans and information for resolution plans).

[**Note:** article 11(1)(b) of *RRD*]

Notification of material change to resolution plan information

11.4.4 R A *firm* or *qualifying parent undertaking* must notify the *FCA* without delay of a change to any of the following which could have materially affect the information in IFPRU 11 Annex 2R (Resolution plan information):

(1) its legal or organisational structure;

(2) its business; or

(3) its financial situation.

[**Note:** article 10(6) second paragraph of *RRD*]

11.5 Intra-group financial support

Application

11.5.1 R This section applies to:

(1) a *firm* that is an *RRD group member*;

(2) a *qualifying parent undertaking* that is an *RRD group member*; and

(3) a *qualifying parent undertaking* that is a *mixed activity holding company* of an *IFPRU 730k firm* in an *RRD group*.

Scope of financial support covered by IFPRU 11.5

11.5.2 G (1) This section applies where an *RRD group member* gives, or proposes to give, intra-*group* financial support using an *RRD group financial support agreement*.

(2) It does not apply to other sorts of intra-*group* financial arrangements, including funding arrangements and the operation of centralised funding arrangements.

(3) It does not apply to financial support arrangements where none of the parties to the arrangement has infringed, or is likely to infringe, an *RRD early intervention condition*.

(4) A *firm* or *qualifying parent undertaking* does not have to use an *RRD group financial support agreement* to give financial support to another *group* member that has infringed, or is likely to infringe, an *RRD early intervention condition*.

(5) A *firm* or *qualifying parent undertaking* may give financial support on a case-by-case basis according to the *group* policies, if the support does not represent a risk for the whole *group*.

[**Note:** article 19(2) and (3) of *RRD*]

Summary of RRD intra-group financial support conditions

11.5.3 G (1) *RRD* recognises a specific form of intra-group financial support. This allows an *RRD group member* in one *EEA State* or a *third country* to give financial support to an *RRD institution* in its *group* in another *EEA State* or *third country*, when that institution has infringed or is likely to infringe an *RRD early intervention condition*.

(2) To give this specific form of financial support an *RRD group member* must use an *RRD group financial support agreement* and satisfy the applicable conditions.

(3) If the *RRD group member* meets the applicable conditions, other *EEA States* will recognise this financial support.

(4) This section sets out the conditions which, in summary, are:

(a) the *consolidating supervisor* of the *group* approves the proposed *RRD group financial support agreement* (see IFPRU 11.5.7 R to IFPRU 11.5.8 G);

(b) the agreement complies with the conditions for entering into an *RRD group financial support agreement* (see IFPRU 11.5.9 R to IFPRU 11.5.13 G);

(c) the financial support complies with the conditions for giving financial support using an *RRD group financial support agreement* (see IFPRU 11.5.14 R to IFPRU 11.5.15 G);

(d) the management bodies of the relevant *group* members take the decision to give and receive financial support (see IFPRU 11.5.16 R to IFPRU 11.5.17 R);

(e) the relevant *group* members notify the relevant authorities of the intention to give financial support (see IFPRU 11.5.18 R to IFPRU 11.5.21 R); and

(f) the relevant *group* members make the relevant disclosures (see IFPRU 11.5.22 R to IFPRU 11.5.23 G).

11

RRD group financial support agreement

11.5.4 G An *RRD group financial support agreement* may:

(1) cover one or more *subsidiaries* of the *group*; and

(2) allow for financial support:

(a) from the *parent undertaking* to *subsidiaries*;

(b) from *subsidiaries* to the *parent undertaking*;

(c) between *subsidiaries* of the *group* that are party to the agreement; or

(d) between any combination of those *group* members.

[**Note:** article 19(5)(a) of *RRD*]

11.5.5 G An *RRD group financial support agreement* may allow for financial support:

(1) in the form of:

(a) a loan;

(b) a guarantee;

(c) the use of assets as collateral; or

(d) any combination of those forms; and

(2) in one or more transactions, including between the beneficiary of the support and a third party.

[**Note:** article 19(5)(b) of *RRD*]

11.5.6 G An *RRD group financial support agreement* may include a reciprocal agreement so the *group* member receiving financial support can give financial support to the *group* member agreeing to give financial support.

[**Note:** article 19(6) of *RRD*]

Approval of RRD group financial support agreements

11.5.7 R (1) The following must apply to their *consolidating supervisor* for approval of any proposed *RRD group financial support agreement* or of any amendment to that agreement:

(a) a *firm* that is the *EEA parent undertaking* of an *RRD group*;

(b) a *qualifying parent undertaking* that is the *EEA parent undertaking* of an *RRD group*; and

(c) an *IFPRU 730k firm* that is a *subsidiary* of an *EEA parent undertaking* of an *RRD group*:

(i) where the *EEA parent undertaking* is an *EEA parent financial holding company* or an *EEA parent mixed financial holding company* that is incorporated in, or formed under, the law of an *EEA State* other than the *United Kingdom*; and

(ii) has the *FCA* as its *consolidating supervisor.*

(2) An application for the approval or amendment of an *RRD group financial support agreement* must:

(a) include the proposed *RRD group financial support agreement*; and

(b) identify the members in the *RRD group* that are intended to be a party to the agreement.

[**Note:** article 20(1) of *RRD*]

11.5.8 G The *FCA* will not approve an *RRD group financial support agreement* unless:

(1) in its opinion, none of the parties has infringed an *RRD early intervention condition* or is likely to infringe one of those conditions in the near future;

(2) the agreement complies with the conditions for entering into an *RRD group financial support agreement* in IFPRU 11.5.9 R to IFPRU 11.5.12 R; and

(3) the terms of the proposed agreement are consistent with the conditions for giving financial support in IFPRU 11.5.14 R.

[**Note:** articles 19(8), 20(1) and 20(3) of *RRD*]

11

Conditions for entering into an RRD group financial support agreement

11.5.9 R The parties to an *RRD group financial support agreement* must include:

(1) one or more of the following:

(a) a *parent institution in a Member State*;

(b) an *EEA parent institution*;

(c) a *financial holding company*;

(d) a *mixed financial holding company*;

(e) a *mixed activity holding company*; and

(2) one or more *subsidiaries* of the *group* member in (1) which is an *RRD institution* or a *financial institution*.

11.5.10 R Before entering into an *RRD group financial support agreement*, a *firm* or *qualifying parent undertaking* must ensure that:

(1) the *RRD group financial support agreement* includes principles for the calculation of the consideration for any support made under it;

(2) these principles include a requirement that the consideration is set when the financial support is given;

(3) each party acts freely and in its own best interests in entering into the *RRD group financial support agreement*;

(4) each party acts in its own best interests in deciding the consideration for the financial support;

(5) each party giving financial support has full disclosure of relevant information from any party receiving financial support before deciding:

(a) the consideration for the support; and

(b) to give the support; and

(6) only the parties to the agreement can exercise any right, claim or action arising from the *RRD group financial support agreement*.

[**Note:** articles 19(7)(a) to (c) and 19(9) of *RRD*]

11.5.11 R When entering into the proposed *RRD group financial support agreement*, a *firm* or *qualifying parent undertaking* must ensure that none of the parties:

(1) has infringed an *RRD early intervention condition*; or

(2) is likely to infringe one of those conditions in the near future.

[**Note:** article 19(8) of *RRD*]

11

11.5.12 R

(1) The principles for calculating the consideration for financial support do not need to take account of any anticipated temporary impact on market prices arising from events external to the *group*.

(2) The consideration for financial support may take account of information that the party giving the support has, based on:

(a) the party giving support being in the same *group* as the party receiving the support; and

(b) the information not being available to the market.

[**Note:** article 19(7)(d) and (e) of *RRD*]

11.5.13 G

In deciding whether a party is acting in its own best interests, the party may take account of any direct or indirect benefit that may accrue to a party as a result of giving financial support.

[**Note:** article 19(7)(b) of *RRD*]

Conditions for giving group financial support using an RRD group financial support agreement

11.5.14 R

A *firm* or *qualifying parent undertaking* must not give financial support using an *RRD group financial support agreement* unless it is satisfied that:

(1) there is a reasonable prospect that giving the support will significantly redress the financial difficulties of the *group* member receiving the support;

(2) the support has the objective of preserving or restoring the financial stability of:

(a) the *group* as a whole; or

(b) any members of the *group*;

(3) the support is in the interests of the *group* member giving the support;

(4) the support is given on terms which meet the conditions in IFPRU 11.5.9 R to IFPRU 11.5.12 R;

(5) there is a reasonable prospect, based on information available to the management body of the *group* member giving the support when it takes the decision to grant support, that:

(a) the consideration for the support will be paid;

(b) if the support is in the form of a loan, the *group* member receiving the support will reimburse the loan; and

(c) if the support is in the form of a guarantee or any form of security, the *group* member receiving the support will reimburse the amount of the guarantee or security if the guarantee or security is enforced;

(6) the support will not jeopardise the liquidity or solvency of the *group* member giving the financial support;

(7) the support will not create a threat to financial stability, in particular in the *United Kingdom*;

(8) the *group* member giving the support complies with the following when giving the support:

   (a) the requirements of the *CRD* relating to capital and liquidity;

   (b) any requirements imposed under article 104(2) (additional own funds requirements) of the *CRD*; and

   (c) the requirements relating to large exposures in the *CRR* and in the *CRD*;

(9) the support will not cause the *group* member giving the support to infringe any of the requirements in (8) as a result of giving the financial support; and

(10) the support will not undermine the resolvability of the *group* member giving the support.

[**Note:** article 23(1) of *RRD*]

11.5.15 G The *FCA* may modify or waive the requirements of IFPRU 11.5.14R (8) if the conditions in section 138A (modification or waiver of rules) of the *Act* are met.

[**Note:** article 23(1)(g) of *RRD*]

Decision to give and receive group financial support using an RRD group financial support agreement

11 11.5.16 R A *firm* or *qualifying parent undertaking* intending to give financial support must ensure that:

(1) its management body takes the decision to give *group* financial support using an *RRD group financial support agreement*; and

(2) it is a reasoned decision that sets out:

   (a) the objective of the proposed support; and

   (b) how the support complies with the conditions for giving *group* financial support using an *RRD group financial support agreement* in IFPRU 11.5.14 R.

11.5.16A G A *firm* or *qualifying parent undertaking* proposing to give financial support using an *RRD group financial support agreement* should also refer to articles 33 to 36 of Commission Delegated Regulation (EU) 2016/1075 of 23 March 2016 supplementing *RRD*:

http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R1075&from=EN.

11.5.17 R A *firm* or *qualifying parent undertaking* intending to receive financial support must ensure that its management body takes the decision to accept the support using an *RRD group financial support agreement*.

[**Note:** article 24 of *RRD*]

Notice of intention to give financial support using an RRD group financial support agreement

11.5.18 R A *firm* or a *qualifying parent undertaking* intending to give financial support using an *RRD group financial support agreement* must ensure that its management body notifies:

(1) its *competent authority*;

(2) where different, its *consolidating supervisor*;

(3) where different, the *competent authority* of the *group* member receiving the financial support; and

(4) the EBA.

11.5.19 R A *firm* or a *qualifying parent undertaking* must:

(1) send a notice of an intention to give financial support before the financial support is given; and

(2) include in the notice:

(a) the reasoned decision referred to in IFPRU 11.5.16 R of the management body of the *group* member intending to give the support; and

(b) details of the proposed financial support including a copy of the *RRD group financial support agreement*.

[**Note:** article 25(1) of *RRD*]

11.5.20 R An *RRD group member* may only give financial support using an *RRD group financial support agreement* if the *FCA* has:

(1) agreed to the giving of the support with restrictions; or

(2) agreed to the giving of the support without restrictions; or

(3) not prohibited the support within five *business days* of receiving a notice of intention to give financial support.

[**Note:** article 25(2) and (5) of *RRD*]

11.5.21 R A *firm* or *qualifying parent undertaking* must ensure it sends the decision of its *management body* to give financial support to:

(1) its *competent authority*;

(2) where different, its *consolidating supervisor*;

(3) where different, the *competent authority* of the *group* member receiving the support; and

(4) the EBA.

[**Note:** article 25(6) of *RRD*]

Disclosure of group financial support using an RRD group financial support agreement

11.5.22 R A *firm* or *qualifying parent undertaking* must:

(1) make public:

(a) whether or not they have entered into an *RRD group financial support agreement*;

(b) a description of the general terms of any *RRD group financial support agreement*; and

(c) the names of the *group* members that are a party to the *RRD group financial support agreement*; and

(2) update the information in (1) at least annually.

[**Note:** article 26 of *RRD*]

11.5.23 G Regulations 431 to 434 of the *EU CRR* apply to the disclosures in IFPRU 11.5.22 R.

[**Note:** article 26(1) of *RRD*]

11.6 Contractual recognition of bail-in

Application

11.6.1 R This section applies to:

(1) an *IFPRU 730k firm* that is not subject to supervision on a *consolidated basis*;

(2) a *firm* that is an *RRD group member*;

(3) a *qualifying parent undertaking* that is an *RRD group member*; and

(4) a *qualifying parent undertaking* that is:

(a) a *mixed activity holding company* of an *IFPRU 730k firm*; and

(b) does not hold an *RRD institution* using an intermediate *financial holding company* or *mixed financial holding company*.

11.6.2 G This section is limited to the types of *mixed activity holding company* in IFPRU 11.6.1R (4) because, in accordance with article 33(3) of *RRD*, it is only these types of *mixed activity holding company* that can be subject to the bail-in provisions of *RRD*.

Contractual recognition of bail-in

11.6.3 R (1) If a liability meets the conditions in (2), a *firm* or *qualifying parent undertaking* must include a term in the contract governing the liability which states that the creditor or party to the agreement creating the liability:

(a) recognises that the liability may be subject to *write-down and conversion powers*; and

(b) agrees to be bound by any of the following actions of a *resolution authority* in relation to that liability:

(i) reduction of principal or outstanding amount due; or

(ii) conversion; or

(iii) cancellation.

(2) The contractual recognition of a bail-in requirement in (1) applies to a liability that is:

(a) governed by the law of a *third country*;

(b) issued or entered into after 1 January 2016;

(ba) issued or entered into before 1 January 2016 but materially amended after 9 December 2016;

(c) of a type that is not excluded under article 44(2) of *RRD*;

(d) not a *deposit* of a type referred to in point (a) of article 108 of *RRD*; and

(e) not a liability which the *resolution authority* has determined can be subject to *write-down and conversion powers* by the *resolution authority* of an *EEA State* under:

(i) the law of a *third country*; or

(ii) a binding agreement concluded with that *third country*.

[**Note:** article 55(1) of *RRD*]

11.6.4 G A *firm* or *qualifying parent undertaking* proposing to provide contractual recognition of bail-in should also refer to articles 42 to 44 of Commission Delegated Regulation (EU) 2016/1075 of 23 March 2016 supplementing *RRD*:

http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R1075&from=EN.

11

11.7 Notifications

Application

11.7.1 R This section applies to:

(1) an *IFPRU 730k firm* that is not subject to supervision on a *consolidated basis*;

(2) a *firm* that is an *RRD group member*;

(3) a *qualifying parent undertaking* that is an *RRD group member*; and

(4) a *qualifying parent undertaking* that is a *mixed activity holding company* of an *IFPRU 730k firm*.

Resolution notifications

11.7.2 R A *firm* or *qualifying parent undertaking* must notify the *FCA* immediately if its management body considers that any of the following have occurred:

(1) the assets of the *firm* or *qualifying parent undertaking* have become less than its liabilities; or

(2) the *firm* or *qualifying parent undertaking* is unable to pay its debts or other liabilities as they fall due; or

(3) there are objective reasons to support a determination that (1) or (2) will occur in the near future; or

(4) *extraordinary public financial support* is needed for the *firm* or *qualifying parent undertaking*, except if it takes any of forms allowed by section 7(5E) of the Banking Act 2009.

11.7.3 R A *firm* must also notify the *FCA* immediately if its *management body* considers that:

(1) the *firm* is failing to satisfy any of the *threshold conditions*, including due to the *firm* having incurred, or being likely to incur, losses that will deplete all, or a significant amount of, its *own funds*; or

(2) there are objective elements to support a determination that the *firm* will fail to satisfy any of the *threshold conditions* in the near future.

[**Note:** article 81(1) of *RRD*]

11

11.7.4 R A *firm* or *qualifying parent undertaking* must notify the *FCA* by sending an e-mail to its usual supervisory contact.

Recovery plans for significant IFPRU firms and group recovery plans for groups that include significant IFPRU firms

(1)	A summary of the key elements of the plan.
(2)	A summary of the overall *recovery capacity* or the capability of the *group* to restore its financial position following a significant deterioration.
(3)	A summary of the material changes to the *firm* or *group* since the most recently filed plan.
(4)	A communication and disclosure plan outlining how the *firm* or *group* intends to manage any potentially negative market reactions.
(5)	A range of capital and liquidity actions required to maintain or restore the viability and financial position of the *firm* or *group*.
(6)	An estimation of the timeframe for executing each material aspect of the plan.
(7)	A detailed description of any material impediment to the effective and timely execution of the plan, including consideration of impact on the rest of the *group*, customers and counterparties.
(8)	An identification of *critical functions*.
(9)	A detailed description of the processes for determining the value and marketability of the *core business lines*, operations and assets of the *firm* or *group*.
(10)	A detailed description of how recovery planning is integrated into the corporate governance structure of the *firm* or *group*.
(11)	The policies and procedures governing the approval of the plan.
(12)	An identification of the persons in the organisation responsible for preparing and implementing the plan.
(13)	The arrangements and measures to conserve or restore the *own funds* of the *firm* on an individual basis and, where applicable, on a *consolidated basis*.
(14)	The arrangements and measures to ensure that the *firm* or *group* has adequate access to contingency funding sources, including potential liquidity sources.
(15)	Where applicable, arrangements for intra-*group* financial support using an *RRD group financial support agreement*.
(16)	An assessment of available collateral.
(17)	An assessment of the possibility to transfer liquidity across *group* members and business lines, to ensure that the *firm* or *group* can carry on its operations and meet its obligations as they fall due.
(18)	Arrangements and measures to reduce risk and leverage.
(19)	Arrangements and measures to restructure liabilities.
(20)	Arrangements and measures to restructure business lines.
(21)	Arrangements and measures necessary to maintain continuous access to financial markets infrastructures.
(22)	Arrangements and measures necessary to maintain the continuous functioning of the operational processes of the *firm* or *group*, including infrastructure and IT services.
(23)	Preparatory arrangements to facilitate the sale of assets or business lines in a timeframe appropriate for the restoration of financial soundness.

(24)		Other management actions or strategies to restore financial soundness and the anticipated financial effect of those actions or strategies.
(25)		Preparatory measures that the *firm* or *group* has taken, or plans to take, to facilitate the implementation of the plan, including those necessary to enable the timely recapitalisation of the *firm* or *group*.
(26)		A framework of indicators which identifies when the appropriate actions in the plan may be taken.
(27)		A wide range of recovery options.
(28)		Appropriate conditions and procedures to ensure the timely implementation of recovery actions.
(29)		The possible measures which could be taken by the *firm* or *group* if a *firm* or any *RRD institution* in a *group* has infringed an *RRD early intervention condition* or is likely to infringe one of those conditions in the near future.
(30)		A contemplation of a range of scenarios of severe macroeconomic and financial stress relevant to the specific conditions of the *firm* or *group*, including system-wide events and stress specific to individual legal persons and to *groups*.
(31)		For each of the scenarios in (30), a *group recovery plan* must identify whether there are:
	(a)	obstacles to implementing recovery measures within the *group*, including at the level of individual members covered by the plan; and
	(b)	substantial practical or legal impediments to the prompt transfer of *own funds* or the repayment of liabilities or assets within the *group*.

[**Note:** articles 5(4), 5(5), 5(6), 7(5), 7(6) and Annex A of *RRD*]

Information for resolution plans

Part A: Corporate structure and material legal entity information

(1) Where an *RRD institution's* parent organisation is a *UK* incorporated entity, a *firm* or *qualifying parent undertaking* should provide the information in Part A for all material legal entities and *branches* that form part of the *group*, both domestic and international, that provide the economic functions identified in Part B below.

(2) Where an *RRD institution's* parent organisation is incorporated outside the *United Kingdom*, a *firm* or *qualifying parent undertaking* should only provide the information required in Part A for:

•*UK subsidiaries* (and any associated overseas *branches*);

•*UK branches* of any overseas *subsidiaries*; and

•material interdependencies with non-*UK persons* in the *group*.

No	Heading	Required data/Detail required [1]
1	**Group structure and key information on legal entities**	
1.1	*Group* structure	An overview diagram of the material legal entities of the *group* and the ownership structure. *Group* structure charts identifying: • the material legal entities in the *group*; • the jurisdiction of those entities; • the relative size of those entities, by showing amount of revenue generated in each entity, assets and total risk exposure amounts held in each entity; and • the total number of material legal entities in the *group*. *Group* consolidated P&L and balance sheet, with the assets broken down between the *trading book* and *non-trading book*.
1.2	Use of *branches* and *subsidiaries*	Provide the following data and analysis for material legal entities. Commentary on the approach to using *branches* and/or *subsidiaries* in different geographies. For each key geography that represents material revenues, profits or activity for the *firm*: • a list of *branches* and *subsidiaries*; and • a description of the business undertaken in each *branch* or *subsidiary*; and • key business metrics and summary P&L and balance sheets on a solo basis, where applicable.
2	**Business model**	
2.1	*Core business lines*	Give an overview of the *firm*'s business model. Identify the business lines which are core to the *group*'s operations and profitability and explain their activities. Highlight if a *branch* or *subsidiary* is material in the local market or critical to the *group*. For each *core business line*, the analysis should include the following.

		• An explanation of the main operations with P&L and balance sheet for each business line. • The locations where the business line operates and corresponding analysis, eg, geographic breakdown of revenue, total operating costs, impairments, profit before tax and assets, as well as the client base and jurisdictions by level of activity. Provide an overview of the *branch* network and any services provided to *clients*, *customers* or other market participants. • For each material *branch* or *subsidiary*, provide an indication of the exposures to each counterparty or *group* of connected counterparties that constitute a material part of that entity's total exposures. • Provide an indication of the franchise value of each business line, eg, where a business line provides networks, international linkages or access to markets which are critical for the overall franchise of the *firm*. • An explanation of the governance structure and division of powers between *group* HQ and *core business lines*. • An explanation of how the business line is organised within the *group*, including a high-level overview of the interaction with other areas and service areas (provide metrics, eg, revenue, P&L where material cross-selling occurs). Is the business line standalone or highly interwoven with the rest of the *group*?
3	**Capital and funding**	
3.1	Capital allocation and mobility	For each material legal entity: • the amount of capital required to support each material legal entity; • the amount of capital currently allocated to each entity; • an explanation of the method of capital provision to each entity; and • details of any maintenance and/or repatriation back to the ultimate parent entity (dividends, coupons, maturity cash flows, etc). Details of at least the following should be supplied for material legal entities: • the minimum capital required by each legal entity to meet the thresholds set by regulators; • an analysis of capital by legal entity on a regulatory basis split into components (CET1, AT1, Tier 2); and • an analysis of capital by legal entity on an accounting basis (permanent share capital, P&L reserves, other reserves, preference shares, subordinated debt and other intermediate capital etc). An explanation of the sources of capital raised for each legal entity, including sources external to the *group*. Quantification of capital which is surplus to regulatory requirements by each entity and in aggregate. Information regarding any restriction on transfers of capital to other *group* entities (dividends, capital contributions, repayments etc) and, in particular, any factors that mean surplus capital held in any entity is not transferable. For each entity, details of material holdings in other *financial institutions*.

3.2	Treasury function	An explanation of how the treasury function is organised. An indication of how quickly capital could be transferred to or from an entity if required and the procedures involved.
3.3	Funding	An overview of funding relationships in the *group*, including the main sources of funding for each material entity and intra-*group* flows of funding split across (i) secured and unsecured and (ii) short-term and long-term categories. [2] *Branches* and *subsidiaries* which are material in intra-*group* funding should be highlighted. A list of current material intra-*group* balances. Details of where there are current and potential impediments to the transfer of liquidity between entities or jurisdictions. A summary of other funding sources not captured elsewhere. Examples include: • off balance sheet funding; and • other sources, including covered bonds, securitisation, repos and other short-term secured financing.
3.4	Intra-*group* guarantees	An overview of intra-*group* guarantees, including: •how, why and when intra-*group* guarantees are used; •the types of guarantees extended (eg, limited, unlimited guarantees) and the parties extending and receiving guarantees. •the total exposures under intra-*group* guarantees, categorised into different types; • an overview of when guarantees can be enforced (including cross-defaults or events of default triggered by resolution); •how intra-*group* guarantees are priced; •a list of the most material intra-*group* guarantees; and •a list of the entities that use, the entities sighted, and the underlying amounts of contracts that contain "Specified Entity" or similar clauses.
3.5	Other financial dependencies	An overview of all other material intra-*group* financial dependencies or exposures, including contingent exposures.
3.6	Encumbrances	For each material legal entity, an overview of which assets on the balance sheet are encumbered as at the last year-end. Highlight if they are intra-*group* or external encumbrances. Information should also be provided on a *group* basis for *UK* headquartered *group*. For international *firms* headquartered outside the *United Kingdom*, operating through *UK subsidiaries*, information should be provided at the *UK* consolidated *group* level. Details of what proportion of each asset class is encumbered and in what manner including: •the proportion which is not subject to any encumbrance; • the proportion encumbered through overcollateralisation; and • an outline of the *firm's* practice on overcollateralisation. Provide an analysis of assets subject to encumbrance by type of instrument, including an approximate split across: securitisations, covered bonds, repo, collateral for OTC derivatives exposure, collateral placed at central banks and any other encumbrances (description of nature and magnitude of other encumbrances should be provided).

		The analysis should also include an assessment of the split of encumbrances between short-term and long-term encumbrances
4	**Activities and operations**	
4.1	Access to financial market infrastructure (FMI)	A brief overview of the *firm*'s access to financial market infrastructure (payment schemes, central counterparties etc), including indirect access to key FMIs. Provide the legal entities that have this access and which entities within the *group* rely on this. To what extent does the *firm* provide market access services/clearing services to third parties globally? Please provide the number of customers. To what extent, globally, does the *firm* rely on other *firms* for these services? What agreements govern these relationships and how will they be affected in a resolution? If relevant and not covered under 2.1, provide an overview of global payments and clearing and settlement business, including a high-level summary on key products/services provided, types of clients serviced, geographical location of business and the FMIs relied upon.
4.2	Risk-management practices	An overview of the *firm*'s booking practices by asset class. Does the *group* manage risk centrally from one entity (please provide main booking hubs by asset class)? To what extent is risk back-to-backed? Give an overview of the *firm*'s margining and collateral management for internal trades. Provide information on any remote booking practices. Provide information on the quantum of risk booked into each material entity. Give an overview of the use of unregulated affiliates globally for booking trades.
4.3	Counterparty risk management	Give an estimate of trades which are booked through an exchange or a central counterparty (*CCP*), trades booked with a bilateral third party and the *firm*'s approach to counterparty risk management. This should include a broad overview on collateral management and the use of netting, including master netting agreements.
4.4	Critical shared services	A summary of how operations are organised in the *firm* or *group*. Provide a high-level summary (including charts where appropriate) of how critical shared services [3] are provided across legal entities, business lines and jurisdictions. At a minimum, split critical services into Treasury, Risk Management, Finance and Operations (this list is not exhaustive). These are services that are crucial to the functioning of the *core business lines* of the *firm*. Please consider, at a minimum (including outsourced services and joint ventures), IT services, staff, premises, licenses and intellectual property. Briefly summarise whether there are contracts which govern the provision of services across business lines, entities and jurisdictions. Provide a brief overview of internal support functions, such as accounting and tax, internal audit and compliance, and human resources. Provide an indication of scale and the location of these functions, including those located outside the *United Kingdom*. Please provide a summary of any pension arrangements within the *group*, including in which legal entity pension liabilities and administration reside. How fully-funded is any pension scheme?

[1] Where a data item is not applicable to a firm or qualifying parent undertaking it should indicate this in its submission of resolution plan information.

[2] Short-term refers to tenor of less than 1 year.

[3] For the purpose of these *rules*, a critical shared service has the following elements:

(i) an activity, function or service is performed by either an internal line, a separate legal entity within the *group* or an external provider;

(ii) that activity, function or service is performed for one or more business lines or legal entities of the *group*; and

(iii) the sudden and disorderly failure or malfunction would lead to the collapse of or present a serious impediment to the performance of, *critical functions*.

Part B: Economic functions

Economic function(s)		**Economic scale metrics**
		(Monetary amounts should be in millions of GBP (£m), unless otherwise stated, to standardise comparison. Where a different currency is used, please provide the exchange rate to be used.)
Capital Markets & Investment	Trading	
	Derivatives (required report see Table 1)	•Total amount of notional outstanding • Total number counterparties For both derivatives positions and derivatives counterparties, split the reports according to the method by which the derivatives are traded or cleared/ settled, ie, (i) exchange traded, (ii) OTC cleared through *CCPs* and (iii) OTC settled bilaterally.
	Trading portfolio (required report see Table 2)	•Balance-sheet values by asset class • Risk-weighted exposure amounts
	Other	
	Asset management	•Amount of assets under management • Total number client accounts • Total client money balances For each of the metrics above, please provide the following information. •The legal entity and jurisdiction of clients. Segregate between institutional, retail and wealth management clients.

		• Estimates of *UK* market share, and identify any issues surrounding replacement of the *firm*'s services by other providers. For investment products, identify those that are eligible and not eligible for protection by the *UK Financial Services Compensation Scheme* (*FSCS*). Please provide the number of customers and total value of account balances: •up to the £50k covered by the *FSCS* •above the £50k covered by the *FSCS* •that are ineligible for protection by the *FSCS*.
Wholesale Funding Markets	Securities financing (required report see Table 3)	•Balance sheet values plus aggregate values for collateral accepted and given • Maturity profile •Total number counterparties, including geographic distribution (number)
	Securities lending	For each of the following activities, whether acting as lender or borrower: •direct securities lending; •third-party securities lending (non-custodian lending) • agent lending (custodian lending); provide: •gross value of open transactions; and • the total number of clients.
Payments, clearing, custody and settlement [4]	Payment services	For all *UK* and material foreign payment systems [5] used, please provide: •the legal entity which holds membership; • transaction volumes (number, monthly/annual average, peak); • transaction values (number, monthly/annual average, peak); •flow volumes (monthly/annual average);

	•number of agents (flow volumes for these provided separately); and •market share ? provide estimate of *UK* market share, as well as overseas market shares where relevant. Please identify any issues surrounding replacement of the *firm's* services by other providers. If required, could the *firm* transition from an affiliate (intra-*group*) network to a third-party correspondent network for payments and clearing? What timeline is required?

[4] The payments, clearing and settlement function is limited to those provided by firms to their clients.

[5] This refers to foreign payment systems in which the *firm* has direct access. Examples include, but not limited to BACS, CHAPS, Faster Payments, cheque clearing system, Fedwire and TARGET2.

Table 1 - Derivatives (complete for each legal entity if firm performs this function)

	Outstanding notional contract amounts (£m)			
	Exchange traded derivatives	Other derivatives cleared through *CCPs*	Over-the-counter derivatives settled bilaterally	Total
Equities				
Sovereign credit				
Non-sovereign credit products				
Rates				
Foreign exchange				
Commodities				

Number of derivative counterparties		
Exchange-traded derivatives	Other derivatives cleared through *CCPs*	Over-the-counter derivatives settled bilaterally

Table 2 - Trading portfolio (complete for each legal entity if firm performs this function):

	Assets (£m)		Liabilities (£m)
	Balance-sheet values	Risk-weighted assets	Balance-sheet values
Equities			
Treasury			
Sovereign credit			
Non-sovereign credit products			
Rates			
Foreign exchange			
Commodities			

Table 3 - Securities financing (complete for each legal entity if firm performs this function)

Reverse repurchase agreements and cash collateral on securities borrowed (£m)	Repurchase agreements and cash collateral on securities lent (£m)	Fair value of securities accepted as collateral under reverse repurchase agreements and securities borrowing transactions (£m)	Fair value of securities given as collateral under repurchase agreements and securities lending transaction (£m)

Table 4 - Table on economic functions split by legal entities

Where a *firm's* parent organisation is a *UK* incorporated entity, *firms* should complete this table for all material legal entities and *branches* that form part of the *group*, both domestically and internationally, where the economic functions are those that have been identified in Part B above. Where a *firm's* parent organisation is incorporated outside the *United Kingdom*, *firms* should only complete this table for:

- *UK subsidiaries* (and any associated overseas *branches*); and

- *UK branches* of any overseas *subsidiaries*.

	Legal entity/ *branch* **1 (£mn)**	**Legal entity/** *branch* **2 (£mn)**	**Legal entity/** *branch* **3 (£mn)**	**Aggregate across legal entities/** *branches* **(£mn)**
Where the *United Kingdom* **is** *Home State*, *firms* **should provide information on all material legal entities/***branches***, even if they do not perform any activity in the** *United Kingdom*.				
Economic function 1 (*eg. asset management***)**				
Economic function 2 (*eg, securities lending***)**				
Where *United Kingdom* **is** *Host State*, *firms* **should provide information on legal entities/***branches* **relevant to the** *United Kingdom* **as stated above.**				
Economic function 1				
Economic function 2				

Prudential sourcebook for Investment Firms

IFPRU TP 1
GENPRU and BIPRU waivers: transitional

		Application
1.1	R	*IFPRU* TP 1 applies to an *IFPRU investment firm*.
1.2	R	*IFPRU* TP 1 applies where immediately before 1 January 2014, a *waiver* given in relation to a *rule* listed in column A of the tables in *IFPRU* 1.9R (Internal model waivers) and TP 1.10R (Other waivers) has effect.
		Duration of transitional
1.3	R	This section applies to each *waiver* in *IFPRU* 1.2 R, until the direction given in respect of that *waiver* ceases to have effect on its terms, or is revoked, whichever is the earlier.
		Transitional
1.4	R	Subject to *IFPRU* TP 1.7R, each waiver given in relation to a *FCA rule* listed in column A of the tables in *IFPRU* TP 1.9R (Internal model waivers) and TP 1.10R (Other waivers) is treated as a permission from the *FCA* to the *firm* under the *EU CRR* article listed in the same row in column B of those tables.
1.5	R	Each permission under *IFPRU* TP 1.4R shall continue to have effect until the expiry date specified in the direction of the relevant *waiver*.
1.6	R	Where a *waiver* listed in *IFPRU* TP 1.9R (Internal model waivers) and TP 1.10R (Other waivers) specifies that it applies to a *firm* on a consolidated basis in accordance with a relevant provision in BIPRU 8 (Group risk consolidation), the permission applies to the *firm* on the basis of its *consolidated situation* in accordance with article 11 of the *EU CRR* (Application of requirements on a consolidated basis: general treatment).
1.7	R	A *waiver* listed in *IFPRU* TP 1.9R (Internal model waivers) only has effect in accordance with this TP where the *firm* has confirmed to the *FCA* that it materially complies with the requirements relevant to the *rules* listed in Column A of the table, as waived or modified by the *waiver*, and any conditions relevant to the application of the *waiver* or the *firm* has a remediation plan.
		Interpretation
1.8	R	For the purpose of *IFPRU* TP 1: (1) "permission" includes a consent, approval or agreement conferred on the *FCA* as a *competent authority* under any *EU CRR* article listed in column B of the tables in *IFPRU* 1.9R (Internal waivers) and *IFPRU* TP 1.10R (Other waivers); (2) any expression used in *IFPRU* TP 1.9R (Internal model waivers) and TP 1.10R (Other waivers) which are defined in the *Glossary* has the meaning in the version of the *Glossary* in force on 31 December 2013; and (3) any reference to *GENPRU* and *BIPRU* is to the version in force on 31 December 2013.
		Tables
1.9	R	Table on internal model waivers

	Permission	Column A FCA Rule (rule waiver or modification)	Column B EU CRR reference
1	Internal Ratings Based (IRB) permission for credit risk	- BIPRU 4 applies to a *firm* with an *IRB permission* - Rules waived or modified: (a) GENPRU 2.1.51 R (b) BIPRU 3.1.1 R	- Part Three, Title II, Chapter 3 - Art 143 - Art 178(1)(b) (where a *firm* is authorised to replace 90 days with 180 days for *exposures* secured by residential or SME commercial real estate in the retail *exposure* class)
2	Eligibility of physical collateral under the IRB Approach	- BIPRU 4.10.16 R (Where authorised by the *firm's IRB permission*)	Art 199(6)
3	Master netting agreement internal models approach	- BIPRU 5.6.1 R, in accordance with BIPRU 5.6.12 R	Art 221
4			[deleted]
5			[deleted]
6			[deleted]
7	Advanced Measurement Approach (AMA) permission	- BIPRU 6.5 applies to a *firm* with an *AMA permission* - *Rule* waived or modified: BIPRU 6.2.1 R	- Art. 312(2) - Part Three, Title III, Chapter 4
8	Combined use of different approaches for operational risk - AMA and Standardised Approach or Basic Indicator Approach	- BIPRU 6.2.9 R (in accordance with BIPRU 6.2.10 G and the *firm's AMA permission*)	Art 314(2) and (3)

	Permission	Column A FCA Rule (rule waiver or modification)	Column B EU CRR reference
9	Permission to use internal models to calculate *own funds requirements* for market risk (Value at Risk)	- BIPRU 7.10 applies to a firm with a *VaR model permission* - *Standard market risk PRR rules* as specified and waived or modified by the *firm's VaR model permission waiver* -GENPRU 2.1.52 R	- Art. 363 - Part Three; Title IV; Chapter 5; Sections 2, 3 and 4
10	Permission to use internal models to calculate *own fund requirements* for the correlation trading portfolio	BIPRU 7.10.55T R to BIPRU 7.10.55ZA R (Where the *firm* is authorised to use the *all price risk measure* in its *VaR model permission waiver*)	Art 377

1.10 R Table on other waivers and requirements

	Permission	Column A FCA Rule (rule waiver or modification)	Column B EU CRR Reference
1	Individual consolidation method	- BIPRU 2.1.7 R (*Solo consolidation waivers*)	Art 9
2	Derogation to the application of *own funds requirements* on a *consolidated basis* for groups of *investment firms*	- BIPRU 8.4 applies to a *firm* with an *investment firm consolidation waiver* - Rules waived: (a) BIPRU 8.2.1 R (b) BIPRU 8.2.2 R (c) BIPRU 8.3.1 R (d) BIPRU 8.3.2 R	Art 15 Art 17
3	Entities excluded from the scope of prudential consolidation	- BIPRU 8.5.9 R -BIPRU 8.5.10 R	Art 19(2)
4	Permission to revert to the use of a less sophisticated approach for credit risk	- BIPRU 4.2.23 R (as modified in accordance with BIPRU 4.2.25 G) - BIPRU 4.2.24 R (as modified in accordance with BIPRU 4.2.25 G)	Art 149
5	Traditional *securitisation* - recognition of significant risk transfer	- BIPRU 9.4.11 R -BIPRU 9.4.12 R (subject to conditions in BIPRU 9.4.15 D)	Art 244(2), (3) and (4)

	Permission	Column A FCA Rule (rule waiver or modification)	Column B EU CRR Reference
6	Synthetic *securitisation* -recognition of significant risk transfer	- BIPRU 9.5.1 R (6) and (7) (subject to conditions in BIPRU 9.5.1B D)	Art 245(2), (3) and (4)
7			[deleted]
8	Permission to revert to the use of a less sophisticated approach for *operational risk*	- BIPRU 6.2.5 R (as modified in accordance with BIPRU 6.2.6 G) - BIPRU 6.2.7 R (as modified in accordance with BIPRU 6.2.8 G)	Art 313
9	Combined use of different approaches for *operational risk* -Standardised Approach and Basic Indicator Approach	- BIPRU 6.2.12 R (as modified in accordance with BIPRU 6.2.13 G)	Art 314(4)
10	Waiver of the three-year average for calculating the *own funds requirement* under the Basic Indicator Approach for *operational risk*	- BIPRU 6.3.2 R (as modified in accordance with BIPRU 6.3.9 G)	Art. 315
11	Waiver of the three-year average for calculating the *own funds requirement* under the Standardised Approach for *operational risk*	- BIPRU 6.4.5 R (as modified in accordance with BIPRU 6.4.8 G)	Art. 317(4)
12	*Own funds requirements* for position risk for options and warrants on: (a) interest rates; (b) debt instruments; (c) equities; (d) equity indices; (e) financial futures; (f) swaps; and (g) foreign currencies	- BIPRU 7.9 applies to a *firm* with a CAD1 model waiver. - *Rules* waived or modified: (a) GENPRU 2.1.52 R (b) BIPRU 7.6.1 R	Art 329

	Permission	Column A FCA Rule (rule waiver or modification)	Column B EU CRR Reference
13	*Own funds requirements* for commodities risk for options and warrants on: (a) commodities; and (b) commodities derivatives	- BIPRU 7.9 applies to a *firm* with a *CAD1 model waiver.* - *Rules* waived or modified: (a) GENPRU 2.1.52 R (b) BIPRU 7.4.1 R	Art 358(3)
14	Interest rate risk on derivative instruments	- *CAD 1 model waiver* for the use of an interest rate pre-processing model in line with BIPRU 7.9.44 G - *Rule* waived: GENPRU 2.1.52 R	Art 331 Art 340
15	Waiver of 100% large exposure limits where the €150 million limit applies	- BIPRU 10.6.32 R (as waived in accordance with BIPRU 10.6.33 G) - SUP 15.3.11 R	Art 396 in relation to the 100% large exposure limit set out in Art 395(1)
16	Waiver of large exposure limits in relation to intra-group exposures: core group waivers	- BIPRU 3.2.25 R (2) - BIPRU 10.8A	Art 113(6) Art 400(1)(f)
17	Waiver of large exposure limits in relation to intra-group exposures: non-core group waivers	- BIPRU 10.9A	Art 400(2)(c), as implemented by *IFPRU* 8.2.4R to 8.2.13R (Intra-group exposures: non-core large exposures group)

1.11 G The *requirement* imposed in relation to a *FCA* rule listed in column A of the table in *IFPRU* 1.12G (Requirements) is treated as imposed under the *EU CRR* article listed in the same row in column B of the table.

1.12 G Table on requirements

	Requirement	Column A FCA Rule	Column B EU CRR Reference
1	Methods of prudential consolidation -art. 12(1) relationship	- BIPRU 8.5.6 R (2)	Art 18(3)
2	Methods of prudential consolidation- Significant influence or single management relationship	- BIPRU 8.5.6 R (2) - "*Article 134 relationship*"	Art 18(6)

Prudential sourcebook for Investment Firms

IFPRU TP 3
Gains and losses

Application

3.1 R *IFPRU* TP 3 applies to an *IFPRU investment firm*, unless it is an *exempt IFPRU commodities firm*.

Purpose

3.2 G *IFPRU* TP 3 contains the *rules* that exercise the discretion afforded to the *FCA* as *competent authority* under articles 467 and 468 of the *EU CRR*. The applicable percentages in *IFPRU* TP 3 apply instead of articles 33(1)(c) (Changes in the value of own liabilities) and 35 (Unrealised gains and losses measured at fair value) of the *EU CRR* for the duration of the transitional.

Duration of transitional

3.3 R *IFPRU* TP 3 applies until 31 December 2017.

Inclusion of unrealised losses at fair value

3.4 R For the purposes of article 467(1) of the *EU CRR*, the applicable percentages are:

1 20% during the period from 1 January 2014 to 31 December 2014;

2 40% during the period from 1 January 2015 to 31 December 2015;

3 60% during the period from 1 January 2016 to 31 December 2016; and

4 80% for the period from 1 January 2017 to 31 December 2017.

[**Note:** article 467(2) of the *EU CRR*]

Removal of unrealised gains at fair value

3.5 R For the purposes of article 468(1) of the *EU CRR*, the applicable percentages are:

1 60% during the period from 1 January 2015 to 31 December 2015;

2 40% during the period from 1 January 2016 to 31 December 2016; and

3 20% for the period from 1 January 2017 to 31 December 2017.

[**Note:** article 468(2) of the *EU CRR*]

Inclusion of fair value gains and losses

3.6 R For the purposes of article 468(4) of the *EU CRR*, the applicable percentages are:

1 20% during the period from 1 January 2014 to 31 December 2014;

2 40% during the period from 1 January 2015 to 31 December 2015;

3 60% during the period from 1 January 2016 to 31 December 2016; and

4 80% for the period from 1 January 2017 to 31 December 2017.

Prudential sourcebook for Investment Firms

IFPRU TP 4
Deductions from own funds

Application

4.1 R *IFPRU* TP 4 applies to an *IFPRU investment firm*, unless it is an *exempt IFPRU commodities firm*.

Purpose

4.2 G *IFPRU* TP 4 contains the *rules* that exercise the discretion afforded to the *FCA* as *competent authority* under articles 469, 474 and 477 of the *EU CRR*. The applicable percentages in *IFPRU* TP 4 apply instead of articles 36(1), 56 (1)(c) and 66 of the *EU CRR* for the duration of the transitional.

Duration of transitional

4.3 R *IFPRU* TP 4 applies until 31 December 2023.

Deduction from common equity tier 1

4.4 R For the purposes of article 469(1)(a) of the *EU CRR*, as it applies to the items in points (b), (d), (f), (g) and (h) of article 36(1) of the *EU CRR* (Deductions from Common Equity Tier 1 items), the applicable percentages are:

(1) 20% during the period from 1 January 2014 to 31 December 2014;

(2) 40% during the period from 1 January 2015 to 31 December 2015;

(3) 60% during the period from 1 January 2016 to 31 December 2016; and

(4) 80% for the period from 1 January 2017 to 31 December 2017.

4.5 R For the purposes of article 469(1)(a) of the *EU CRR* as it applies to the items in points (a), (e) and (i) of article 36(1)) of the *EU CRR* (Deductions from Common Equity Tier 1 items), the applicable percentages are:

(1) 100% during the period from 1 January 2014 to 31 December 2014;

(2) 100% during the period from 1 January 2015 to 31 December 2015;

(3) 100% during the period from 1 January 2016 to 31 December 2016; and

(4) 100% for the period from 1 January 2017 to 31 December 2017.

4.6 R For the purposes of article 469(1)(c) of the *EU CRR*, as it applies to the items in point (c) of article 36(1)) of the *EU CRR* (Deductions from Common Equity Tier 1 items) that existed prior to 1 January 2014, the applicable percentages are:

(1) 0% for the period from 1 January 2014 to 31 December 2014;

(2) 10% for the period from 1 January 2015 to 31 December 2015;

(3) 20% for the period from 1 January 2016 to 31 December 2016;

(4) 30% for the period from 1 January 2017 to 31 December 2017;

(5) 40% for the period from 1 January 2018 to 31 December 2018;

(6) 50% for the period from 1 January 2019 to 31 December 2019;

(7) 60% for the period from 1 January 2020 to 31 December 2020;

(8) 70% for the period from 1 January 2021 to 31 December 2021;

(9) 80% for the period from 1 January 2022 to 31 December 2022; and

(10) 90% for the period from 1 January 2023 to 31 December 2023.

4.7 R For the purposes of article 469(1)(c) of the *EU CRR*, as it applies to the items in point (c) of article 36(1)) of the *EU CRR* (Deductions from Common Equity Tier 1 items) that did not exist prior to 1 January 2014, the applicable percentages are:

(1) 20% during the period from 1 January 2014 to 31 December 2014;

(2) 40% during the period from 1 January 2015 to 31 December 2015;

(3) 60% during the period from 1 January 2016 to 31 December 2016; and

(4) 80% for the period from 1 January 2017 to 31 December 2017.

Deductions from additional tier 1 items

4.8 R For the purposes of article 474(a) of the *EU CRR*, the applicable percentages are:

(1) 20% during the period from 1 January 2014 to 31 December 2014;

(2) 40% during the period from 1 January 2015 to 31 December 2015;

(3) 60% during the period from 1 January 2016 to 31 December 2016; and

(4) 80% for the period from 1 January 2017 to 31 December 2017.

Deductions from tier 2 items

4.9 R For the purposes of article 476(a) of the *EU CRR*, the applicable percentages are:

(1) 20% during the period from 1 January 2014 to 31 December 2014;

(2) 40% during the period from 1 January 2015 to 31 December 2015;

(3) 60% during the period from 1 January 2016 to 31 December 2016; and

(4) 80% for the period from 1 January 2017 to 31 December 2017.

Prudential sourcebook for Investment Firms

IFPRU TP 5
Own funds: other transitionals

Application

5.1 R *IFPRU* TP 5 applies to an *IFPRU investment firm*, unless it is an *exempt IFPRU commodities firm*.

Purpose

5.2 G *IFPRU* TP 5 contains the *rules* that exercise the discretion afforded to the *FCA* as *competent authority* under articles 479 to 480 of the *EU CRR*. The applicable percentages in *IFPRU* TP 5 apply for the duration of the transitional.

Duration of transitional

5.3 R *IFPRU* TP 5 applies until 31 December 2021.

Recognition of instruments and items not qualifying as minority interests

5.4 R For the purposes of article 479(2) of the *EU CRR*, the applicable percentages are:

(1) 0% during the period from 1 January 2014 to 31 December 2014;

(2) 0% during the period from 1 January 2015 to 31 December 2015;

(3) 0% during the period from 1 January 2016 to 31 December 2016; and

(4) 0% for the period from 1 January 2017 to 31 December 2017.

Recognition of minority interests and qualifying additional tier 1 and tier 2 capital

5.5 R For the purposes of article 480(1) of the *EU CRR*, the applicable factors are:

(1) 0.2 during the period from 1 January 2014 to 31 December 2014;

(2) 0.4 during the period from 1 January 2015 to 31 December 2015;

(3) 0.6 during the period from 1 January 2016 to 31 December 2016; and

(4) 0.8 for the period from 1 January 2017 to 31 December 2017.

Additional filters and deductions

5.6 R For the purposes of article 481(1) of the *EU CRR*, the applicable percentages are:

(1) 0% during the period from 1 January 2014 to 31 December 2014;

(2) 0% during the period from 1 January 2015 to 31 December 2015;

(3) 0% during the period from 1 January 2016 to 31 December 2016; and

(4) 0% for the period from 1 January 2017 to 31 December 2017.

Limits on grandfathering

5.7 R For the purposes of article 486 of the *EU CRR* the applicable factors are:

(1) 80% during the period from 1 January 2014 to 31 December 2014;

(2) 70% during the period from 1 January 2015 to 31 December 2015;

(3) 60% during the period from 1 January 2016 to 31 December 2016;

(4) 50% during the period from 1 January 2017 to 31 December 2017;

(5) 40% during the period from 1 January 2018 to 31 December 2018;

(6) 30% during the period from 1 January 2019 to 31 December 2019;

(7) 20% during the period from 1 January 2020 to 31 December 2020; and

(8) 10% during the period from 1 January 2021 to 31 December 2021.

Prudential sourcebook for Investment Firms

IFPRU TP 6
Leverage

		Application
6.1	R	*IFPRU* TP 6 applies to an *IFPRU investment firm*.
		Purpose
6.2	G	*IFPRU* TP 6 contains the *rules* that exercise the discretion afforded to the *FCA* as *competent authority* under article 499(3) of the *EU CRR*. IFPRU TP 6 applies instead of article 429(2) of the *EU CRR* (Leverage) for the duration of the transitional.
		Duration of transitional
6.3	R	*IFPRU* TP 6 applies until 31 December 2017.
		End-of-quarter level ratio
6.4	R	A *firm* may calculate the end-of-quarter leverage ratio instead of the leverage ratio that is an arithmetic mean of the monthly leverage ratios over a quarter.

Prudential sourcebook for Investment Firms

IFPRU TP 7
Capital conservation buffer: transitional

		Application
7.1	R	*IFPRU* TP 7 applies to an *IFPRU investment firm*, unless it is an *IFPRU limited licence firm* or *exempt IFPRU commodities firm*.
		Purpose
7.2	G	This section implements article 160 of *CRD* in relation to the *capital conservation buffer*. The amounts of the *capital conservation buffer* in *IFPRU* TP 7 apply instead of the amount of the *capital conservation buffer* in IFPRU 10.2.1 R (Main requirement) for the duration of the transitional.
		Duration of transitional
7.3	R	*IFPRU* TP 7 applies with effect from 1 January 2016 (which is the date that IFPRU 10.2 (Capital conservation buffer) comes into effect) until 31 December 2018.
		Modified main requirement
7.4	R	This *rule* modifies IFPRU 10.2.1 R (Main requirement) in the following manner: (1) from 1 January 2016 until 31 December 2016, the *capital conservation buffer* is the amount of *common equity tier 1 capital* equal to 0.625% of a *firm's total risk exposure amount*; (2) from 1 January 2017 until 31 December 2017, the *capital conservation buffer* is the amount of *common equity tier 1 capital* equal to 1.25% of a *firm's total risk exposure amount*;; and (3) from 1 January 2018 until 31 December 2018, the *capital conservation buffer* is the amount of *common equity tier 1 capital* equal to 1.875% of a *firm's total risk exposure amount*.

Prudential sourcebook for Investment Firms

IFPRU TP 8
Countercyclical capital buffer: transitional

8.1	R	[expired]
8.2	G	[expired]
8.3	R	[expired]
8.4	R	[expired]
8.5	R	[expired]
8.6	R	[expired]
8.7	R	[expired]
8.8	R	[expired]
8.9	R	[expired]
8.10	R	[expired]
8.11	R	[expired]

Prudential sourcebook for Investment Firms

IFPRU TP 9
Large exposures limits

		Application
9.1	R	IFPRU TP 9 applies to an *IFPRU investment firm*, unless it is an *exempt IFPRU commodities firm*.
		Purpose
9.2	G	IFPRU TP 9 contains the *rules* that exercise the discretion afforded to the *FCA* as *competent authority* under article 493(4) to (7) of the *EU CRR*. The applicable limits in IFPRU TP 9 apply for the duration of the transitional.
		Duration of transitional
9.3	R	IFPRU TP 9 applies until 31 December 2020.
		Large exposures limits
9.4	R	For the purposes of article 493(4) of the *EU CRR*, a *firm* may incur any of the exposures provided for in article 493(5) of the *EU CRR* meeting the conditions set out in article 493(6) of the EU CRR, up to the following limits: (1) 100% of the *firm's common equity tier 1 capital* and *additional tier 1 capital* until 31 December 2018; (2) 75% of the *firm's common equity tier 1 capital* and *additional tier 1 capital* until 31 December 2019; and (3) 50% of the *firm's common equity tier 1 capital* and *additional tier 1 capital* until 31 December 2020.

Prudential sourcebook for Investment Firms

Schedule 1
Record-keeping requirements

Sch 1 G

(1)	The aim of the *guidance* in the following table is to give the reader a quick overall view of the relevant record keeping requirements.
(2)	It is not a complete statement of those requirements and should not be relied on as if it were.
(3)	Table

Handbook reference	Subject of record	Contents of record	When record must be made	Retention period
IFPRU 2.2.43R and 2.2.44R	*Firm*'s assessment of its financial resources	(1) The major sources of risk the *firm* has identified (2) How the *firm* intends to deal with those risks (3) Details of the stress and scenario analyses carried out and the resulting financial resources estimated to be required	Not specified	At least three years
IFPRU 4.3.17 G	Documents relating to rating systems	All documentation relating to a *firm*'s rating systems (including any document referenced in IFPRU 4 or required by the *EU CRR* that relate to the IRB approach)	Not specified	At least three years

Prudential sourcebook for Investment Firms

Schedule 2
Notification and reporting requirements

Sch 2 G

(1)	The aim of the *guidance* in the following table is to give the reader a quick overall view of the relevant notification requirements.
(2)	It is not a complete statement of those requirements and should not be relied on as if it were.
(3)	Table

Handbook reference	Matter to be notified	Contents of notification	Trigger event	Time allowed
IFPRU 1.3.1 R	Results of calculations for supervisory benchmarking of internal approaches	Results of the calculations of a *firm's internal approaches* for its *exposures* or positions included in benchmark portfolios and an explanation of the methodologies uses	Calculation of the results of its *internal approaches*	Annually
IFPRU 1.5.1 R	Notification of FINREP reporting	Matters as described in IFPRU 1.5.1 R	Matters as described in IFPRU 1.5.1 R	No later than five *business days* from when an *IFPRU investment firm* identifies that it is a *FINREP firm* that is required to report FINREP or that is no longer required to submit FINREP.
IFPRU 2.2.31R	Changes to evaluation as a result of change in interest rates	Decline in economic value of the firm by more than 20% of its *own funds*	Change in interest rates	Not specified
IFPRU 2.2.37R(6)	Results of stress test and scenario analysis	Results of stress test and scenario analysis	Completion of stress test and scenario analysis	Annually, not later than three *months* of its annual reporting date
IFPRU 3.2.6 R	Intention to enter into a connected transaction	Fact of intention and details of each connected transaction sufficient to allow evaluation	Intention to enter into a connected transaction	At least one *month* prior to entry into the relevant transaction

IFPRU 3.2.8 R	*Additional tier 1 instrument* or tier 2 instrument governed by the law of *third country* are capable of being written down or converted into common equity tier 1 instrument	Information sufficient to demonstrate that any *additional tier 1 instrument* or tier 2 instrument issued by the *firm* that are governed by the law of *third country* are capable of being written down or converted into common equity tier 1 instrument to the same extent as an equivalent *own funds* instrument, including a properly reasoned legal opinion from an individual appropriately qualified in the relevant *third country*	Intention to issue	Not specified
IFPRU 3.2.10 R	Intention by *firm* or member of its *group* to issue a capital instrument, other than common equity tier 1 capital, for inclusion in *own funds*	Fact of intention and information in IFPRU 3.2.12 R, eg, details of intended amount, issue date, type of investor, stage of capital, features of instrument and confirmation of compliance with the conditions for qualification as *own funds*	Intention to issue	One *month* prior to issue
IFPRU 3.2.13 R	Intention by *firm* or member of its *group* to issue ordinary *shares* or debt instrument issued under a debt securities programme previously issued	Confirmation that terms of the capital instrument have not changed since the previous issue of that type of capital instrument and information in IFPRU IFPRU 3.2.12 R (1) and (3), eg, details of intended amount, issue date, type of investor, stage of capital, features of instrument and confirmation of compliance with the conditions for qualification as *own funds*	Intention to issue	No later than the date of issue

IFPRU 3.2.15 R	Proposed changes to details of the issue of a capital instrument notified	Proposed change to intended date of issue, amount of issue, type of investors, type of *own funds* or other feature	Intention to change any details of the issue previously notified to the *FCA*	As soon as changes are proposed
IFPRU 3.2.16 R	Intention by *firm* or member of its *group* member to amend or vary details of a capital instrument included in *own funds* or consolidated *own funds*	Proposed change and all information required under IFPRU 3.2.12 R (1) to IFPRU 3.2.12 R (4)	Intention to change any details of the issue previously notified to the *FCA*	One *month* prior to intended date of amendment
IFPRU 3.2.17 R	Intention by *firm* or member of its *group* member to reduce *own funds* or consolidated *own funds*	Actions described in article 77 of the *EU CRR*	Intention to carry out the actions described in article 77 of the *EU CRR*	As soon as intention is formed
IFPRU 4.12.1 R	Reliance on deemed transfer of significant risk under articles 244(2) and 245(2) of the *EU CRR*, including for the purposes of article 337(5) of the *EU CRR*	Sufficient information to allow the *FCA* to assess whether the possible reduction in risk-weightedexposure amounts achieved by the *securitisation* is justified by a commensurate transfer of credit risk to third parties	Intention to rely on deemed transfer of significant risk	Within a reasonable period before or after a relevant transfer, not being later than one *month* after the date of transfer
IFPRU 8.2.5 G IFPRU 8.2.5R(4)	Intention to concentrate intra-group *exposures* to *group* members in excess of 25% of *core UK group eligible capital*	Explanation of how IFPRU 8.2.5R(1) is met on a continuing basis and details of the counterparty, the size and expected duration of the *exposure*	Intention to concentrate intra-group *exposures* to *group* members in excess of 25% of *core UK group eligible capital*	Prior written notice before the *exposures* are concentrated
IFPRU 8.2.5R(6)	After ceasing to have concentration intra-group *exposures* in excess of 25% of *core UK group eligible capital*, intention to start to do so again	Explanation of how IFPRU 8.2.5R(1) is met on a continuing basis, details of the counterparty, the size and expected duration of the *exposure* and the reason for the *exposure*	Intention to start to concentrate intra-group *exposures* to *group* members in excess of 25% of *core UK group eligible capital*	Prior written notice before the start of concentrating *exposures* again
IFPRU 10.4.3 R (2)	Failure to meet the *combined buffer*	Failure to meet the *combined buffer*	Failure to meet the *combined buffer*	No later than five *business days* from when it identified its failure

IFPRU 10.4.3 R (9)	Intention to distribute any distributable profits or undertake any action under IFPRU 10.4.3 R (2)	Matters described in IFPRU 10.4.3 R (9)(a) to (d)	Intention to distribute any distributable profits or undertake any of the specified action	Not less than one *month* before intended date of distribution or action
IFPRU 10.5.2 R	Capital conservation plan	Capital conservation plan	Failure to meet the *combined buffer*	No later than five *business days* from when it identified its failure
IFPRU 11.2.15 R	*Recovery plan* actions	A decision to take an action referred to in a *recovery plan* or a decision not to take action	The decision to take action or not to take action	Without delay
IFPRU 11.3.17 R	*Group recovery plan* actions	A decision to take an action referred to in a *group recovery plan* or a decision not to take action	The decision to take action or not to take action	Without delay
IFPRU 11.4.4 R	Resolution plan information	The change to the information in IFPRU Annex 2R (Resolution plan information)	A change to the legal or organisational structure of the *firm* or *group*, its business or its financial situation, which could materially affect the information in IFPRU Annex 2R (Resolution plan information)	Without delay
IFPRU 11.5.18 R	Giving *group* financial support using an *RRD group financial support agreement*	The reasoned decision of the management body in line with IFPRU 11.5.16 R and the details of the proposed financial support including a copy of the *RRD group financial support agreement*	An intention to provide *group* financial support using an *RRD group financial support agreement*	Before providing the support
IFPRU 11.5.21 R	Giving *group* financial support using an *RRD group financial support agreement*	The decision of the *management body* of the *RRD institution* to give financial support	The decision to give financial support	Not specified
IFPRU 11.7.2 R, and IFPRU 11.7.3 R	Resolution notifications	Matters described in IFPRU 11.7.2 R and IFPRU 11.7.3 R	The occurrence of the situations described in IFPRU 11.7.2 R, or IFPRU 11.7.3 R	Immediately on the occurrence of the situations described in IFPRU 11.7.2 R or IFPRU 11.7.3 R

Prudential sourcebook for Investment Firms

Schedule 3
Fees and other requirement payments

Sch 3 G
There are no requirements for fees or other payments in *IFPRU*.

Prudential sourcebook for Investment Firms

Schedule 4
Intentionally left blank

Sch 4
Intentionally left blank

Prudential sourcebook for Investment Firms

Schedule 5 Rights of action for damages

Sch 5 G

(1)	The table below sets out the rules in *IFPRU* contravention of which by an *authorised person* may be actionable under section 138D of the Act (Actions for damages) by a person who suffers loss as a result of the contravention.
(2)	If a "Yes" appears in the column headed "For private person", the *rule* may be actionable by a private person under section 138D (or, in certain circumstances, his fiduciary or representative; see article 6(2) and (3)(c) of the Financial Services and Markets Act 2000 (Rights of Action) Regulations 2001 (SI 2001/2256)). A "Yes" in the column headed "Removed" indicates that the *FCA* has removed the right of action under section 138D(3) of the *Act*. If so, a reference to the rule in which it is removed is also given.
(3)	The column headed "For other person" indicates whether the *rule* may be actionable by a *person* other than a private person (or his fiduciary or representative) under article 6(2) and (3) of those Regulations. If so, an indication of the type of *person* by whom the *rule* may be actionable is given.

Chapter/ Appendix	Section/Annex	Right of action under section 138D		
		For private person	Removed	For other person
All *rules* in *IFPRU*		No	Yes - IFPRU 1.6.1 R	No

Prudential sourcebook for Investment Firms

Schedule 6
Rules that can be waived

Sch 6 G

The rules in *IFPRU* may be waived by the *FCA* under section 138A of the *Act* (Modification or waiver of rules). However, if the *rules* incorporate requirements laid down in European directives or regulations, it will not be possible for the *FCA* to grant a *waiver* that would be incompatible with the *UK*'s responsibilities under those directives and regulations. It therefore follows that if a *rule* in *IFPRU* contains provisions which derive partly from a directive or regulation, and partly not, the *FCA* will be able to consider a *waiver* of the latter requirements only, unless the directive or regulation provisions are optional rather than mandatory