

Chapter 8

Prudential consolidation and large exposures

8.1 Prudential consolidation

Application

8.1.1

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- (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

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- 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

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- (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.....

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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.

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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*.

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

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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*]

8.2.8 **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.

