INTERIM PRUDENTIAL SOURCEBOOK FOR BANKS (AMENDMENT AND CONSEQUENTIAL AMENDMENTS TO THE HANDBOOK) INSTRUMENT 2002

Powers exercised

A. The Financial Services Authority makes this instrument in the exercise of the power in section 157(1) of the Financial Services and Markets Act 2000 (Guidance).

Commencement

B. This instrument comes into force on 1 February 2003.

Amendments to the Interim Prudential sourcebook for banks

C. The Interim Prudential sourcebook for banks is amended in accordance with Annex A to this instrument.

Amendments to the Interim Prudential sourcebook for building societies

D. The Interim Prudential sourcebook for building societies is amended in accordance with Annex B to this instrument.

Amendments to the Authorisation manual

E. The Authorisation manual is amended in accordance with Annex C to this instrument.

Citation

F. This instrument may be cited as the Interim Prudential Sourcebook for Banks (Amendment and Consequential Amendments to the Handbook) Instrument 2002.

By order of the Board
19 December 2002

Annex A

Amendments to IPRU(BANK)

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

The Annex is divided into three parts as follows:

Part 1 sets out amendments to Chapter CO section 4 (which is reproduced in its entirety) to set out the procedure for setting, reviewing and monitoring capital ratios.

Part 2 sets out consequential amendments required as a result of Part 1 amendments.

Part 3 sets out amendments to Chapter CO section 1 to update references to certain EC directives.

Part 1

Chapter CO section 4

4 Individual capital ratios ~~Trigger and target ratios~~

This section explains the FSA's policy for the setting, reviewing and monitoring of capital ratios and provides an overview of factors it takes into account in setting the level of the ratios. The first sub-section explains the procedure for the setting of the ratios. The second sub-section deals with their monitoring.

4.1 Setting and reviewing the ratios

4.1.1 Individual capital ratios ~~Trigger ratios~~

See s2.1

1 The third element of the FSA's capital adequacy framework is the setting of a capital ratio for a certain quantity of risk weighted assets. This is the *individual capital ratio (ICR)* ~~*trigger ratio*~~, the minimum capital ratio that the FSA considers a bank should maintain.

See ch GN (s3)

2 Rule [3.3.13 in Chapter GN] requires a bank to maintain adequate capital resources. In order to meet this requirement the FSA considers that banks should maintain, on a continuing basis, the capital ratios advised by the FSA. In the event that a ratio is not met, the bank should contact the FSA immediately.

3 The absolute minimum ICR ~~trigger ratio~~ the FSA considers to be appropriate is 8% as set out in the SRD (now replaced by The Banking Consolidation Directive), but in practice the FSA expects most banks to work to an ICR ~~trigger ratio~~ which is significantly above this figure.

4 The FSA considers that an ICR of 8% (i.e. the minimum) is appropriate only for a well-diversified firm whose business, management, systems and controls are strong and where the risks that it is exposed to are captured adequately by the capital model. For a bank that does not satisfy these conditions, the FSA will use the Individual Capital Ratios Framework (ICRF) to determine an ICR above the 8% minimum (see FSA Policy Statement 'Individual Capital Ratios for Banks', July 2001).

The ICRF is a structured framework which is used by the FSA to identify potential sources of risk not captured - or not captured adequately - by the 8% minimum capital ratio. FSA supervisors gather information on these potential risks, drawing on our primary risk assessment tools as well as other information sources. The ICRF is then used to build up a qualitative risk assessment for the bank and to determine an appropriate capital ratio to help mitigate these risks. The ICRF lists those risk factors where the FSA deems capital to be an appropriate mitigant.

~~The trigger ratio for a bank is set relative to those assigned to other members of its peer group, with variations to take into account any special characteristics and particular concentrations of risks the individual bank may have.~~ The ~~F~~factors considered ~~include~~ are:

Banking Book	**Trading Book**
Business Risk	***Business Risk***
Section 1 – Model Fit	Section 1 – Model Fit
Interest rate risk in the banking book	Market risk
Settlement risk	Incremental capital for large exposures
Credit risk	Underwriting
Risks on the liability side	CAD1 & CAD2 models
Interaction between credit and market risks	Legal, Operational and Other business risks
Legal, Operational and Other business risks	
Section 2 – Concentration / Operating Environment	Section 2 – Concentration / Operating Environment
Concentration	Concentration
Access to capital	Access to capital
Consolidation	Consolidation
Infrastructure	Infrastructure
Banking Book	**Trading Book**
Control Risk	***Control Risk***
Section 3 – Control factors	Section 3 – Control factors
Internal controls	Internal controls
Organisation	Organisation
Management	Management

~~(a) the character of the bank (size, risk profile, the volatility of its earnings);~~

~~(b) the character of the markets in which it operates (political and economic stability, risk, price volatility, liquidity, etc.);~~

~~(c) diversification of activities and types of assets;~~

~~(d) the degree of concentration of counterparty exposure in a bank's portfolio;~~

~~(e) the experience and quality of management and other personnel;~~

~~(f) the adequacy of systems and controls;~~

~~(g) shareholder/controller support and control;~~

~~(h) the degree of supervision by other regulators (especially relevant for subsidiaries of overseas banks); and~~

(i) ~~if a bank securitises some of its assets, the trigger ratio should reflect the asset quality in the residual balance sheet and any operational risk relating to the assets removed from the supervisory balance sheet.~~

5 The ICR ~~trigger ratio~~ is reviewed periodically to ensure that it continues to reflect the bank's risk-profile. In the event of a significant deterioration in a bank's risk profile, the FSA may consider that the ratio should be increased to reflect the increased risk; the converse applies to improvements in a bank's risk profile.

*4.1.2 **Capital buffers** ~~**Target ratios**~~*

6 SYSC 3.2.6R requires a bank to take reasonable care to maintain effective systems and controls for compliance with regulatory requirements. This includes compliance with Rule [3.3.13 in Chapter GN]. In doing so a bank should take into account the ICR(*s*) advised by the FSA. In order to ensure continued compliance with Rule [3.3.13 in Chapter GN], the FSA believes it is appropriate for a bank to maintain a capital buffer above the level of the ICR advised by the FSA. The size of this buffer is at the discretion of the bank. However, if the bank's capital falls below the ratio(s) advised by the FSA, this will call into question the effectiveness of the firm's risk management procedures. In such circumstances, the FSA would have to consider an appropriate regulatory response.

~~The purpose of the target ratio is to act as a "warning light" that the cushion of capital resources normally considered adequate to prevent an accidental breach of trigger is being eroded.~~

~~a) The difference between trigger and target ratios for a bank depends upon the nature of its business and its exposure to seasonal variations or changes in the business cycle.~~

4.1.3 CAD banks

7 For CAD banks, separate ICRs ~~trigger and target ratios~~ are set for the trading and banking books.

a) Because the banking book regime is expressed in terms of a ratio in proportion to risk weighted assets, whilst the trading book regime established by the CAD expresses its requirement as capital 'haircuts' (i.e. the level of capital required to support an associated risk), a method

is needed to allow trading book ICRs ~~trigger ratios~~ to be brought into the framework. This is achieved by multiplying the trading book aggregate capital haircut by 12.5 to produce a notional risk weighted asset equivalent which can be multiplied by the trading book ICR ~~trigger ratio~~. This system is purely supervisory and banks should not publish their ratios in this form.

4.2 Monitoring and breaches

4.2.1 Monitoring

8 For normal reporting purposes, the extent to which a bank exceeds its capital requirements is expressed as a percentage of that capital requirement. So a bank's supervisory capital adequacy position should always be above 100%.

9 The monitoring of capital ratios by the FSA normally takes place using the quarterly (solo) and semi-annual (consolidated) BSD3 return. However, in the event of a programme of remedial action being agreed (particularly in the case of breaches of ICR ~~trigger~~) the FSA may request more frequent information.

10 A bank must maintain adequate capital on a continuing basis, not just on reporting dates. Where the nature of the activities is such that the capital ratio remains stable, the calculation may be on an appropriate periodic basis. It may, however, be appropriate that a bank is able to monitor its capital ratios daily.

11 Any fall, or anticipated fall, below the ICR ~~target or trigger~~ by a bank should be notified to the FSA immediately it becomes known.

~~***4.2.2 Planned breaches of target ratio***~~

~~12 In the event of a planned breach of target ratio, a bank should demonstrate to the FSA's satisfaction that it has both adequate systems to monitor its position in relation to its target ratio on a continuing basis (as with its trigger ratio) and the ability to restore its actual ratio above target.~~

~~***4.2.3 Unplanned breaches of target ratio***~~

~~13An unplanned breach of target ratio may indicate that a bank is in danger of becoming capital deficient. The FSA would discuss a programme of remedial action and a specific timetable with a bank in such circumstances.~~

4.2.2 Breaches of the ICR ~~trigger ratio~~

14 Any breach of the ICR ~~trigger ratio~~ by a bank is a serious matter since it indicates that a bank may have insufficient capital safely to support the risks in its business and might well ~~may therefore~~ be unable to meet the requirements and standards under ~~of~~ the regulatory system ~~Act~~.

4.3 Consolidated ratios

15 The capital ratio set by the FSA on a consolidated basis is normally the same as that set on a solo basis for the principal bank in the group.

See ch CS a) For further details, see the chapter on consolidated supervision.

Part 2

Chapter CO section 1

CAPITAL ADEQUACY OVERVIEW

…

1.4 7	How this chapter is organised … Section 4 provides details of the use of individual capital ratios ~~trigger and target capital ratios~~.

…

Chapter CO section 2

2. THE FSA'S APPROACH TO CAPITAL ADEQUACY

2.1 1 …	… The structure of the FSA's capital adequacy framework … (c) A capital ratio. a) This is a ratio of total capital to risk-weighted assets and thus generates a level of capital for a bank's activities which it should maintain. The structure chosen - which involves individual capital ratios ~~trigger and target ratios~~ is set out below.

…

Chapter CO section 3

3. THE FRAMEWORK FOR CALCULATING CAPITAL REQUIREMENTS

3.1 … 3	Introduction … The basic principle is that the framework generates a notional weighted risk asset figure for a bank's risk, which should be multiplied by the bank's relevant *individual capital ratio* ~~*trigger* or *target capital ratio*~~ to generate the level of capital which the FSA considers a bank should maintain. …

…

Chapter CO section 5

5 APPENDIX: OPTIMISING THE USE OF CAPITAL IN CAPITAL ADEQUACY CALCULATIONS

… 3	… (b) Calculate trading book capital requirements. Trading book ICR ~~trigger~~ = X% …
	(c) Calculate banking book capital requirements. Banking book ICR ~~trigger~~ = Y% …

…

Chapter CA - Section 4

4 ELEMENTS OF A BANK'S CAPITAL BASE

…

4.4 Tier 3 – ancillary capital

…

(a) …

(ii) The terms of the debt should provide that if the bank's allowable capital falls below its individual capital ratio ~~target capital requirement~~ the FSA must be notified and the debt repayments must be suspended.

…

Chapter CA - Section 5

5 TIER 1 CAPITAL

…

5.3. …

…

9 …

b)…

i) ~~In some cases a bank's calculation of its capital position on this basis might show that it has fallen beneath its target capital requirement. The FSA takes account of the uplift expected to be produced by the subsequent audit of profits in deciding on its supervisory response to this happening. The FSA expects banks to inform it of the effect of this adjustment, as well as of the declaration of the dividends, as soon as it becomes apparent. The FSA does not consider it acceptable for a bank to fall below its *trigger capital requirements* in anticipation of subsequent verification of profits.~~

ii) ~~For the definition of *trigger and target capital requirements* see overview of capital chapter.~~

…

Chapter CA - Section 6

6.6 **Criteria for subordinated debt to be included in Upper Tier 2**

7 …

(b) …

b) After five years consent to a net redemption can be given where the FSA is satisfied that the bank will remain above its <u>individual capital ratio</u> ~~target ratio~~ without resort to new capital issues for at least two years. Banks should produce a capital plan showing that they will remain above their <u>individual capital ratio</u> ~~target ratio~~ for at least two years after repayment. For details of what should be included in a capital plan see the section on the repayment of capital.

…

Chapter CA – Section 8

8.2 General conditions

1 …

(e) Repayment: …

b) Prior to agreeing to early repayment the bank should provide the FSA with a capital plan showing that its capital will remain adequate (above its individual capital ratio ~~target ratio~~) after repayment, and that it is likely to remain so for at least two years. For details of capital plans see section on repayment of capital.

8.5 Issuing debt

8.5.1 Procedures for issuing subordinated loan capital

…

18 The debt agreement for issues of Tier 3 subordinated debt should contain a warning to investors that the FSA may require payments of principal or interest to be suspended if the bank's total eligible capital falls below its individual capital ratio ~~target capital requirement~~. A bank using subordinated debt under an agreement entered into before [date of revised guidance coming into effect] should consider whether the removal of the concept of the target ratio that took effect on that date prejudices the operation of that agreement in such a way that the debt no longer satisfies the conditions in this chapter. However, the FSA expects that most such documents would have been drafted sufficiently widely to accommodate that change.

a) The individual capital ratio ~~target capital requirement~~ means the individual capital ratio ~~target supervisory capital adequacy ratio~~ as calculated on the Form BSD3, and does not refer only to the trading book individual capital ratio ~~target capital requirement~~.

…

Chapter CA - Section 9

9.2. Short-term subordinated debt

2 …

(b) The terms of the debt should provide a *lock-in clause* that if the bank's total eligible capital falls below its individual capital ratio ~~target capital requirement~~ then the FSA should be notified and the FSA may require that interest and principal payments be deferred on Tier 3 debt until the bank's capital position returns above its individual capital ratio ~~target capital requirement.~~ A firm using Tier 3 debt under an agreement entered into before 1 February 2003 should consider whether the removal of the concept of the target ratio that took effect on that date, prejudices the operation of that agreement in such a way that the debt no longer satisfies the conditions in this chapter. However, the FSA expects that most such documents would have been drafted sufficiently widely to accommodate that change.

a) The individual capital ratio ~~target capital requirement~~ means the bank's individual capital ratio ~~target supervisory capital adequacy ratio~~ as calculated on the Form BSD3, and does not refer only to the trading book capital requirement.

…

Chapter CA - Section 12

12.1 Repayment of Tier 1 capital

1 In general a bank should only repay or return Tier 1 capital where it has sufficient remaining Tier 1 to cover 60% of its individual ~~target~~ capital requirement. This test applies to external repayments (but not intra-group capital repayments by FSA-regulated consolidated banking groups) and should be passed at both the solo and the consolidated level.

a) In this context the individual ~~target~~ capital requirement is defined as the bank's individual capital ratio ~~target RAR~~ multiplied by weighted risk

assets, plus supervisory deductions.

b) The reason for defining the capital requirement in this way (as opposed to simply referring to 60% of the bank's individual capital ratio ~~target RAR~~) is to ensure that the bank has sufficient Tier 1 to cover 60% of the capital needed to cover all parts of the group, including those where the FSA's supervisory treatment is capital deduction (e.g. life assurance companies) rather than line by line consolidation.

2 …

(a) Demonstrate that the bank will remain in excess of its (group and solo) capital individual capital ratios ~~target ratios~~ (as defined above) for two years without relying on new capital issues;

…

(c)…

b) For repayment of intra-group capital it is normally sufficient for a bank to be above its individual capital ratio ~~target ratio~~ immediately after repayment, i.e. the need to remain above the individual capital ratio ~~target ratio~~ for at least two years does not apply.

12.2 Repayment of Tier 2 capital

3 No early repayment of Tier 2 capital should be made without the FSA's prior agreement. The FSA will only agree to early repayment where a bank produces a capital plan, as described in the section on repayment of Tier 1 capital that shows that the bank will remain above its individual capital ratio ~~target ratio~~ for at least two years after the repayment.

a)As with Tier 1, for repayment of intra-group capital it is normally sufficient for a bank to be above its individual capital ratio ~~target ratio~~ immediately after repayment, i.e. the need to remain above the individual capital ratio ~~target ratio~~ for at least two years does not apply.

…

Chapter TI - Section 4

4 GENERAL MARKET RISK CALCULATION

…

4.1 Introduction

3 …

a) However, it recognises that yield curves in some currencies are more volatile and that their markets are less liquid with fewer hedging mechanisms available. When a bank has a portfolio with material interest risk in such currencies, this will be taken fully into account when setting the ~~target and trigger~~ individual capital ratio(s).

…

Chapter LE - Section 8

8.1 Large exposures policy statements

…

3 …

(g) the bank's approach to top slicing;

a) The FSA still does not condone the practice of *top slicing*. …The FSA takes such activity into account when assessing a bank's risk profile and may, as a result, adjust the bank's individual capital ratio(s) ~~risk asset trigger and target ratios~~ accordingly.

…

Chapter LE - Section 9

9.2 Exempt exposures

9.2.6 Parental guarantees

14 …

(c) …

d) …

ii) A *capital maintenance* agreement is an undertaking by the parent bank to provide sufficient capital to restore the subsidiary bank's risk asset ratio to above its supervisory individual capital ratio ~~target ratio~~ if exposures covered by the agreement subsequently become non-performing. A bank should pre-notify an exposure covered by an agreement but the risk is not transferred to the parent bank.

…

Chapter CS - Section 3

3.1.1 *Capital adequacy*

…

3 Where a bank fails to meet its consolidated individual capital ratio ~~trigger capital ratio~~, the FSA considers whether this poses a threat to the bank, so requiring it to consider whether to take action.

…

(b) …

a) The action needed may be, for example, to pursue the controller for a rectification of the capital position, to raise individual capital ratios ~~trigger and/or target ratios~~, to require better liquidity or to restrict lending to other group companies.

…

Chapter CS - Section 6

6.1.4 *Capital adequacy*

6 …

The only "*exceptional circumstances*" which are currently considered to be relevant are when a '*trading*' *investment firm* is found to have a large volume of non-trading assets which appear to have been booked to it in order to circumvent a banking book individual capital ratio ~~trigger~~ - in other words, where the assets should be classified as banking book assets. In such cases, the firm's assets should be split into trading and non-trading - the latter being consolidated line-by-line into the banking book.

…

Chapter CS - Section 7

7.2 **Consolidating using aggregation plus**

… …

3	Where appropriate in cases 2(a) and (b) above, the notional weighted risk assets should be converted into a capital requirement, by multiplying them by the individual capital ratio ~~trigger ratio~~ applied to the subsidiary (typically 8%). In case 2(c), notional weighted risk assets are converted by multiplying by the trading book individual capital ratio ~~trigger ratio~~ set by the FSA.
	…
4	When using aggregation plus and receiving the written agreement of the FSA, a bank may satisfy itself on a daily basis that it meets its individual capital ratio ~~trigger ratio~~ set by the FSA with reference to position limits, as opposed to actual positions.

…

Chapter CS - Section 10

10.5 Appendix E: Calculation of consolidated capital adequacy

… …

7 Suppose also that the following applies:

Consolidated banking book risk weighted assets:	B_A
Trading book notional risk weighted assets:	T_A
- consolidated, using line-by-line	T_A
- parent bank	T_p
- banking subsidiary, using FSA rules:	T_{b1}
- banking subsidiary, using host supervisor rules	T_{b2}
- investment subsidiary, using FSA rules:	T_{i1}
- investment subsidiary, using local supervisor rules	T_{i2}

These assumptions assume capital regimes for the trading activities that produce trading both notional risk weighted assets (and not simply a capital requirement).

Banking book individual capital ratio ~~trigger~~	y%
Trading book individual capital ratio ~~trigger~~	x%

…

Chapter SE - Section 4

4.3 Operational risks

5 The FSA takes into account any significant operational risks not related to balance sheet items when setting a bank's minimum (“individual”) ~~(“trigger”)~~ capital ratio. In exceptional cases it may wish to apply an explicit capital requirement against this sort of risk.

…

Chapter CD - Section 3

3.3 Other operational risks

4 The FSA takes into account significant operational risks when setting a bank's minimum (or “individual”) ~~(or “trigger”)~~ capital ratio, and may in exceptional cases set an explicit capital requirement against such risk.

…

Chapter TV - Section 4

4.1 Introduction

…

2 Accordingly, there are a number of qualitative standards which should be met and these are set out below. The extent to which banks meet the qualitative standards may influence the level at which the FSA will agree the trading book individual capital ratio ~~trigger ratio~~ or the *multiplication factor*.

a) The trading book individual capital ratio ~~trigger ratio~~ is explained in the chapter on the overview of capital adequacy.

…

c) A bank's failure to meet the qualitative standards in full will affect the multiplication factor if the failure is confined to activities subject to the model. If the failure relates to trading book activities in general, then the bank's supervisor will consider it when agreeing the trading book individual capital ratio ~~trigger ratio~~. Failure to meet a qualitative standard in full will not affect both the multiplication factor and the trading book individual capital ratio ~~trigger ratio~~.

…

Chapter TV - Section 11

11.1 Introduction

…

…

4 The aggregate capital requirement for the trading book should then be subject

to the trading book individual capital ratio ~~trigger ratio~~. See the chapter on the overview of capital adequacy.

Chapter NE - Section 4

4.3 Common treatment of collateral in the banking and trading book

4.3.1 Forms of collateral

… …

15 …

a) Top slicing is the practice by which a bank systematically collateralises only the element of the exposure that exceeds the 25% limit to bring it within the limit or collateralises only the element of an exposure that exceeds 10% of the bank's large exposures capital base in order to bring the sum of such exposures below the clustering limit. The FSA takes such activity into account when assessing a bank's risk profile and may, as a result, adjust the bank's individual capital ratio(s) ~~trigger and target risk asset ratios~~ accordingly.

Part 3

Chapter CO section 1

1.2	**Legal sources**
3	…
	Two ECU Directives between them set out the main components of the capital adequacy structure:
	• Title V, Chapter 2, Section 1 of The Banking Consolidation Directive (formerly the Own Funds Directive "OFD" - 89/299/EEC) defines what is regarded as a bank's capital resources for supervisory purposes.
	• Title V, Chapter 2, Section 2 of The Banking Consolidation Directive (formerly the Solvency Ratio Directive "SRD" - 89/647/EEC) assigns weightings to the various classes of assets and establishes the minimum Risk Asset Ratio.
	• The Capital Adequacy Directive ("CAD", 93/6/EC) and its subsequent amendment (98/31/EC) extends the regime to cover additional aspects of market risk.

1.3 5	**Application** … c) Overseas banks are not subject to European Directives, but The Banking Consolidation Directive (2000/12/EC) (formerly the OFD and SRD among other directives) follows closely the principles laid down in the 1988 Basel Agreement, and hence are in the main followed by most banks overseas, particularly those in other G10 countries. In concept, these rules have become the internationally accepted standard.

Annex B

Amendments to IPRU(BSOC)

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

VOLUME 1

4 Financial risk management

Annex 4B

…

Chapter CD - Section 3

…

3.3 **Other operational risks**

4 The FSA takes into account significant operational risks when setting a bank's minimum (or "individual") ~~(or "trigger")~~ capital ratio, and may in exceptional cases set an explicit capital requirement against such risk.

…

10 Securitisation

10.1 Introduction

…

10.1.3 G …

(3) In paragraph 5 in section 4.3 of chapter SE, the reference to a "bank's minimum (or individual) ~~(or "trigger~~") capital ratio" should be read as "a building society's threshold solvency ratio".

…

SE: Section 4

…

4.3. **Operational risks**

5 The FSA takes into account any significant operational risks not related to balance sheet items when setting a bank's minimum ("individual") ~~("trigger")~~ capital ratio. In exceptional cases it may wish to apply an explicit capital requirement against this sort of risk.

Annex C

Amendments to AUTH

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

3.8.6G An applicant in the prudential category of *bank* or *insurer* should note that the *FSA* will give it individual guidance on its likely capital requirements: for example, the individual capital ratios ~~trigger ratios~~ for a *bank* (see *IPRU(BANK) COB* 4.1.1(Individual capital ratios ~~Trigger rations~~)) or the capitalisation or solvency margin of an *insurer* (see *IPRU(INS)* 2 (Margins of solvency)) during pre-application discussions (see *AUTH* 3.9.2G).