PRUDENTIAL SOURCEBOOK FOR INVESTMENT FIRMS (PILLAR 2 AMENDMENTS) INSTRUMENT 2016

Powers exercised

A. The Financial Conduct Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):

(a) section 137A (The FCA's general rules);
(b) section 137T (General supplementary powers);
(c) section 138D (Action for damages); and
(d) section 139A (Power of the FCA to give guidance).

B. The rule-making powers referred to above are specified for the purpose of section 138G(2) (Rule-making instruments) of the Act.

Commencement

C. This instrument comes into force on 22 April 2016.

Amendments to the Handbook

D. The Prudential sourcebook for Investment Firms (IFPRU) is amended in accordance with the Annex to this instrument.

Notes

E. In the Annex to this instrument, the "notes" (indicated by "**Note:**") are included for the convenience of readers but do not form part of the legislative text.

Citation

F. This instrument may be cited as the Prudential Sourcebook for Investment Firms (Pillar 2 Amendments) Instrument 2016.

By order of the Board
21 April 2016

Annex

Amendments to the Prudential sourcebook for Investment Firms (IFPRU)

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

2 Supervisory processes and governance

[**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/.]

2.1 Application and purpose

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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 Internal capital adequacy assessment process

Adequacy of financial resources

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2.2.4 G ~~The liabilities referred to in the *overall financial adequacy rule* include a *firm's* contingent and prospective liabilities. They exclude liabilities that might arise from transactions that a *firm* has not entered into and which it could avoid (eg, by taking realistic management actions such as ceasing to transact new business after a suitable period of time has elapsed). They include 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. They also include 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.~~

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).

…

Strategies, processes and systems

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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.

…

Market risk

…

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

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

…

General stress and scenario testing

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2.2.37 R

…

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

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

…

Capital planning

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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.

…

Pension obligation risk

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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 itself~~ scheme's risks themselves (~~ie,~~ 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, ~~it should reverse out any accounting deficit and replace this in its capital adequacy assessment with its best estimate, calculated in discussion with the scheme's actuaries or trustees, of the cash that will need to be paid into the scheme in addition to normal contributions over the~~

~~foreseeable future. This may differ from the approach taken in assessing pension scheme risks for the purposes of calculating *own funds* to meet the own funds requirements.~~ 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) …

(2) one in which the pension scheme position deteriorates (~~eg,~~ 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.

…

2.3 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

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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*.

…

The ICAAP and the SREP: the ICAAP

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

…

(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*;

…

2.3.5 G <u>(1)</u> 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<u>:</u>

<u>(a)</u> diversification benefits and transferability of resources between members of the group ~~and~~<u>;</u>

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

<u>(c)</u> 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 ~~individualand~~ <u>individual and</u> consolidated basis)).

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

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The ICAAP and the SREP: the SREP

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2.3.12 G <u>(1)</u> 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*.

<u>(2)</u> 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), <u>and the extent to which the *firm* has used any of the capital buffers that are required of it under the *CRD*,</u> as applicable.

<u>(3)</u> 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.

…

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* ~~*own funds requirements*~~ <u>*total risk exposure amount*</u> plus one or more static add-ons for specific risks, in line with the *overall Pillar 2 rule*.