

## 5: Draft amendments to new draft supervisory statement – The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP) for Small Domestic Deposit Takers (SDDTs)

In this appendix, new text is underlined and deleted text is struck through.

### 2. Expectations of SDDTs undertaking an ICAAP

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#### Credit risk mitigation: guarantees and credit derivatives qualifying as unfunded credit protection

2.17 For SDDTs using the Risk Weight Substitution Method~~Standardised Approach for credit risk~~, the Credit Risk Mitigation (CRR) Part of the PRA Rulebook allows SDDTs to recognise guarantees or credit derivatives qualifying as unfunded credit protection, ~~by substituting the risk weight of an obligor with the risk weight of a guarantor, for the protected amount of the exposure (ie the risk weight substitution method).~~ SDDTs are expected to assess whether there are any residual risks and evidence this assessment within the ICAAP document. ~~a full substitution of the risk weight of the guarantor is warranted or not.~~ As part of this assessment, SDDTs should consider the risk that, notwithstanding the fulfilment of eligibility criteria under Pillar 1 for qualifying guarantees or credit derivatives, the credit protection could in practice become ineffective due to any reason other than the default of the protection provider~~guarantor and evidence this assessment within its ICAAP document.~~ As part of this consideration, the PRA expects SDDTs to consider in particular the:

- risk, if any, that in practice the protection provider~~guarantor~~ would seek to reduce or be released from liability under the credit protection~~guarantee~~, for example through lengthy settlement or disputes processes; and
- operational risk that the SDDT may breach its obligations under the terms of the credit protection~~guarantee~~ in a manner that might entitle the protection provider~~guarantor~~ not to pay out.

2.18 Where SDDTs assess that there are residual risks and apply either the Risk Weight Substitution Method, a full substitution is not prudent, the PRA expects SDDTs to consider whether a Pillar 2A add-on is appropriate.

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## Pension obligation risk

2.70 ~~[Deleted] The PRA's framework for Pillar 2A pension obligation risk capital consists of two elements:~~

- ~~• the SDDT's own assessment of the appropriate level of Pillar 2A pension obligation risk capital; and~~
- ~~• a set of stresses on the accounting basis which will be used by the PRA in assessing the adequacy of the SDDT's own assessment of the level of capital required.~~

2.71 ~~[Deleted] The SDDT's own assessment and the stress tests on the accounting basis can be reduced by:~~

- ~~• offsets and management actions; and~~
- ~~• any pension scheme deficit deducted from Common Equity Tier 1 (CET1).~~

2.72 The PRA expects SDDTs to carry out their own assessment of the appropriate level of Pillar 2A pension obligation risk capital in their ICAAP. SDDTs~~Firms~~ should use methodologies and assumptions that are consistent with their approach to risk management and are therefore not restricted to using their relevant accounting basis (IAS 19 or similar) ~~basis~~ in carrying out this assessment.

2.72A The assessment should be proportionate to the nature, scale and complexity of the SDDT's activities, considering factors such as the size of the scheme, the scheme's funding level, investment strategy and the presence of secured benefits.

2.73 In carrying out their assessment, SDDTs should consider risks to the financial position of their pension schemes consistent with a stress event that has no more than a 1 in 200 probability of occurring over~~in~~ a one-year period.

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2.74A Following a buy-in, as part of the firm's ICAAP assessment, the PRA would expect consideration to be made for the residual risks remaining, such as counterparty risk to the insurer. The ICAAP should document the firm's assessment of these risks.

2.74B The firm's own assessment can be reduced by:

- offsets and management actions; and
- any pension scheme deficit deducted from Common Equity Tier 1 (CET1).

~~2.75 [Deleted] As part of their ICAAP submission, SDDTs are required to calculate and (if they have a defined benefit pension scheme) report the stressed accounting value of their pension scheme's assets and liabilities using stress scenarios specified by the PRA in accordance with the draft SoP 'The PRA's methodologies for setting Pillar 2 capital for Small Domestic Deposit Takers (SDDTs)' and Reporting Pillar 2 2.6 as set out in the PRA Rulebook. This requirement is in addition to the SDDT's own assessment referred to above, unless the data required in that data item have already been reported to the PRA by other means. In doing so SDDTs are expected to:~~

- ~~• calculate the stressed value of assets and liabilities assuming all the elements of the stress apply instantaneously and simultaneously;~~
- ~~• decompose the IAS 19 discount rate into a risk-free element and a credit spread element. Firms should make use of their own methodology to do so but should provide a description of the approach taken in their ICAAP. The long-term interest rate stress should be applied to the risk-free element and the credit stress to the credit spread element in order to derive the stressed discount rate; and~~
- ~~• use their own methodology to decompose the yield on bonds into a risk-free element and a credit spread element and describe the approach taken in their ICAAP.~~

~~2.76 [Deleted] The PRA expects the valuation measure of liabilities to be the same as that used for International Financial Reporting Standards (IFRS) reporting. The PRA expects SDDTs' approaches to setting the valuation assumptions to be stable over time and any changes to the approach should be justified in the ICAAP document.~~

~~2.77 [Deleted] More information on the scenarios is available in the draft SoP 'The PRA's methodologies for setting Pillar 2 capital for Small Domestic Deposit Takers (SDDTs)'. The PRA scenarios are highly simplified by design and SDDTs should decide which stresses to apply to individual asset and liability classes. The broadest possible interpretation should be used (eg a single stress is specified for equity prices); and this should be applied to all~~

~~categories of investments that exhibit properties similar to listed equities, such as UK equities, overseas equities, unlisted equities, private equity and limited partnerships.~~

~~2.78 [Deleted] Where SDDTs believe that the scenarios produce inappropriate levels of capital for their pension schemes, they should provide evidence of this together with a detailed explanation in their ICAAP document.~~

2.79 The PRA expects SDDTs to explain any offsets or management actions they propose. When considering management actions and offsets, SDDTs must clearly demonstrate that offsets are valid and that management actions are realistic. They must also demonstrate that both offsets and management actions do not result in double counting and would be effective under stressed conditions. Where practical, management actions will be formulated after discussion with pension scheme trustees.

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