POLICY STATEMENT ON GROUPS POLICY AND DOUBLE LEVERAGE

The UK Prudential Regulation Authority published its Policy Statement: Groups Policy and Double Leverage, on 30 April 2018. The Policy Statement addresses various group-level prudential regulatory issues. The over-arching theme is a concern that compliance with formal consolidated group prudential requirements may leave gaps and mismatches in risk coverage across a group. The PRA will therefore consider, and require its supervised groups to consider, such group-wide issues more specifically and comprehensively through the ICAAP/SREP and Pillar 2 process: but does not commit itself to imposing quantified additional capital requirements.

Key issues

- The PRA has published its Policy Statement on Groups Policy and Double Leverage
- The Policy Statement focuses in particular on mismatches and divergences of capital requirements on group and individual entity levels
- This is of particular interest when considered against the backdrop of recent, and the potential for post-Brexit, changes in capital requirements
- It also considers the distribution of financial resources throughout a group, mirroring recent focus on pre-positioning internal MREL/TLAC

INTRODUCTION

The UK Prudential Regulation Authority (**PRA**) published a Policy Statement (**PS9/18**) on Groups Policy and Double Leverage on 30 April 2018. The Policy Statement follows and provides the PRA's feedback on responses to the PRA's Consultation Paper of October 2017 (**CP19/17**), and confirms the position set out in the CP.

The Policy Statement addresses the prudential regulation of the (mostly UK-based) bank and investment firm groups supervised by the PRA, and focuses on three key issues:

- Double leverage, at an unregulated holding company level;
- Risks arising from mismatches between consolidated group capital requirements and aggregate individual capital requirements (especially due to the imposition of stricter local requirements); and
- Distribution of capital and liquidity resources throughout a group.

The Policy Statement comes at a time of significant ongoing regulatory developments impacting directly and indirectly the structure and composition of UK and EU banking groups including the implementation of the UK bank ring-fencing regime, developing standards for internal MREL, and EU proposals for the introduction of holding company authorisation requirements and intermediate parent undertaking requirements (under the CRD V proposals). The changes to be brought about by the Policy Statement do not amount to anything quite so radical or significant as the foregoing reforms, but they refract or cast light on several of the themes addressed by such wider developments.

The positions set out in PS9/18 and CP19/17 will be implemented through changes to various PRA rules and Statements with effect from 1 January 2019.

Double leverage

Double leverage refers to situations where a holding company issues debt or other lower-quality capital and invests the proceeds in equity or other regulatory capital instruments issued by its subsidiaries.

Ordinarily, double leverage most commonly arises where an unregulated holding company owns regulated subsidiaries. This is because, whilst the subsidiaries are subject to capital requirements (and therefore must issue higher quality capital instruments to their parent, the holding company), the holding company is not subject to such requirements, and may therefore fund its investments with the issuance of lower quality capital instruments. Double leverage is sometimes perceived by regulators as a risk as, among other things, it may incentivise holding companies to exert pressure on their subsidiaries to return capital, or pursue an aggressive dividend policy, in order to enable the holding company to meet its debt servicing and repayment requirements.

The mischief posed by double leverage is largely remedied by the imposition of consolidated group capital requirements, pursuant to the Capital Requirements Regulation 575/2013/EU. Consolidated capital requirements, in effect, require a parent to maintain regulatory capital of sufficient quality and quantity to support the capital requirements of its consolidated group.

However, the PRA is concerned that double leverage may nonetheless occur in prudentially supervised groups, especially where a holding company's regulated subsidiaries are subject to stricter capital requirements than those of the consolidated prudential regime applicable to the group as a whole. Such circumstances may arise where such subsidiaries have significant capital add-ons that are not reflected at a group level, where they are subject to a different regulatory regime altogether, or where their individual capital requirements are driven by significant intra-group exposures, which are eliminated on consolidation (and therefore do not drive group capital requirements). The risk of double leverage arising has arguably increased in recent years, as post-GFC prudential regulatory reforms have led to a generalised increase in individual and sub-consolidated-level capital requirements, which may not have been matched by consolidated group-level increases.

Rather than introduce quantified additional group capital requirements, the PRA will require PRA-authorised firms to assess and mitigate the risks arising from double leverage, where their parent has a double leverage ratio (i.e. the ratio of the equity capital investment in subsidiaries divided by its own adjusted equity capital) of 100% or more. In the intervening period since publishing CP19/17, the PRA has clarified its position by addressing double leverage arising at the level of intermediate parents.

In procedural terms, this will be effected through the ICAAP/SREP process, and in the setting of Pillar 2 capital requirements at a consolidated group level.

By requiring firms to assess and mitigate risks in non-specified terms (rather than imposing mandatory capital add-ons regardless), the PRA is implicitly acknowledging that the imposition of additional group capital requirements may not always be the appropriate or necessary means of addressing double leverage. This is significant when viewed against the backdrop of Brexit, and the possibility that EU supervisors may impose higher capital requirements upon the EU subsidiaries of UK banks.

Prudential requirements imposed by host regulators

More generally, the PRA has clarified its expectations as to how prudential risks faced by a group should be assessed and addressed at a consolidated group level. The PRA draws attention to the fact that individual entity requirements may not necessarily be fully reflected by capital requirements at a consolidated group level, especially in the case of systemically important bank groups, where local D-SIB buffers may exceed the relevant local entity's share in the group G-SIB buffer. This general point has much in common with concerns relating double leverage (although the focus is on quantum, rather than quality of capital), and can also be viewed against the Brexit-backdrop (although the PRA does not expressly refer to it).

The PRA is therefore requiring its supervised groups to consider and highlight such mismatches in their group ICAAP submissions, and to explain the steps taken to mitigate such mismatches: as with double leverage, the PRA does not commit itself to imposing quantified capital add-ons, although it notes that it will take into account such mismatches when setting Pillar 2A and the PRA Buffer.

The PRA has acknowledged that similar mismatches may occur in liquidity requirements, but has indicated that, for now, it maintains a watching brief on such requirements.

Distribution of capital and liquidity resources throughout a group

Consolidated group requirements aim to ensure that groups have sufficient financial resources to meet the overall capital and liquidity requirements of the group. However, consolidated group requirements are somewhat blunt tools, as they do not determine where such financial resources should be held and accordingly whether such resources will actually be effective in absorbing losses or meeting liquidity requirements as they arise (bearing in mind that resources are not always freely transferable around a group). The PRA's focus has therefore turned to ensuring that such resources are pre-positioned in appropriate places, mirroring the Bank of England and other resolution authorities' current concerns to develop requirements for the proper placement of internal MREL/TLAC resources.

As some respondents to CP19/17 have pointed out, the fact that entities within a group are subject to capital and liquidity requirements on an individual basis should automatically ensure that financial resources are appropriately distributed throughout the group. However, the PRA notes in response that groups may comprise many entities that are either subject to lighter touch capital or liquidity requirements or not subject to such requirements at all on an individual basis (but whose positions still contribute to consolidated requirements and whose failure may lead to reputational or other consequences for the group as a whole) – therefore a conscious effort needs to be made to ensure that they have access to sufficient financial resources.

The PRA is not imposing hard quantitative requirements relating to the allocation of resources throughout the group, but rather requires firms to take general steps to ensure the appropriate allocation of such resources throughout the group and to evidence such steps in their ICAAP documents. The underlying rules requiring this have formally been part of the PRA rulebook since 2014, and so this may best be viewed as a concentration of focus, or a marker of forthcoming scrutiny, rather than a fundamental shift in requirements.

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